

**LEGISLATIVE PROPOSAL 08-3 (SUBPART F INCOME)
 JANUARY 15, 2008, INTERESTED PARTIES MEETING
 QUESTIONS/RESPONSES**

Item #	Question	Response
1	In section 25117(a) of the proposed amendments, what is meant by “is treated as a dividend actually paid?” Is clarity needed?	The legislative proposal treats Subpart F income as a deemed dividend, even though nothing is actually “paid.” The intention of this phrase is to remove any potential ambiguity relating to the interaction of other code provisions that refer to a dividend “paid” or “received,” by specifying in the language that Subpart F income shall be treated as a dividend actually paid for all purposes. Franchise Tax Board (FTB) staff believes no additional clarity is necessary because the language states “for all purposes.”
2	Would there be circumstances when an actual dividend paid by a Controlled Foreign Corporation (CFC) would be subject to sections 24411 or 25106 instead of receiving previously taxed income (PTI) treatment?	In some cases, there may be overlap between PTI distributions and sections 24411 or 25106. The federal Subpart F rules provide a special ordering rule that accelerates earnings and profits eligible for PTI before all other earnings and profits are taken into account. Legislative Proposal (LP) 08-3 would conform to the federal special ordering rules. To the extent that a draw from earnings and profits of a given year is simultaneously eligible for treatment as PTI and is excluded from income under sections 24411 or 25106, a taxpayer should not be eligible to claim an exclusion that exceeds the amount of the distribution. Staff will recommend clarifying language to provide to that effect.
3	In section 25117(b)(6) of the proposed amendments, why is FTB changing current law to disallow a separate California election for the Subpart F High Foreign Tax exception?	The goal of this proposal is to significantly 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. LP 08-3 was designed so that taxpayers could simply pick up the amounts of federal Subpart F income, PTI, and stock basis. The federal high-tax election is very

		<p>complex. It is made on a country-by-country, CFC by CFC, and income item-by income item basis. It requires obtaining detailed foreign country tax law information and CFC income and expense data, making a number of difficult calculations and the application of special foreign tax credit rules that do not otherwise apply for California purposes. Allowing a California-only high tax election runs counter to the proposal's goal of simplicity because it would result in substantial state and federal differences in PTI and the CFC's stock basis, and could result in complex state audits on the eligibility and calculation of the "state only" High Foreign Tax exception. In addition, for nearly a decade, the FTB has regularly supported legislation that would require binding federal elections with no separate California election.</p>
4	Should clarifying language be added to the proposed amendments related to the inclusion of Subpart F income in the sales factor?	<p>FTB staff believes that clarifying language is unnecessary. The proposal's language specifically states that Subpart F income shall be treated as a dividend actually paid. The Subpart F income would be included in the numerator and denominator of the sales factor using the same rules for assigning dividend income to the sales factor when a "real" dividend is paid. See Legal Rulings 2003-03 and 2006-01.</p>
5	Could section 24425 be applied to the 27% dividend-received deduction amount?	<p>Because the foreign investment interest offset (section 24344(c)) applies to interest expense, and serves a similar purpose to section 24425, there would probably not be any adjustment for interest under section 24425. However, section 24425 might apply to expenses other than interest consistent with the broad principles of <i>Great Western Financial Corp. v. Franchise Tax Board</i> (1971) 4 Cal.3d 1.</p>
6	Will taxpayers get factor representation in addition to the 27% dividends-received deduction?	<p>No. Under this proposal, CFC's are no longer included in the water's-edge combined report, therefore, a CFC's apportionment factors are excluded. The tax effects of the CFC's apportionment factors under current law have been reflected in the calculation of the 27% dividends-received deduction for Subpart F income (deemed</p>

		dividend) included in the income of the members of the water's-edge group. "Factor relief" would require gathering essentially the same data as current law, which would run counter to the simplification goal of the proposal. In addition, "factor relief" would also require a reduction in the dividend received deduction attributable to Subpart F income, in order to maintain revenue neutrality.
7	There is a question about federal foreign dividends. It appears they would be subject to a 75% dividends-received deduction, but it is not clear whether the same dividends could be eliminated if they traced back to years in which the company filed worldwide rather than water's-edge.	Under existing law (Cal. Code of Regs., tit. 18, section 24411), dividends that are eligible for elimination under section 25106 take precedence over dividends eligible for the 75% dividend received deduction of section 24411. Under this proposal, for distributions of PTI from years before the effective date of LP 08-3 (i.e., the transitional PTI rules), PTI might be attributable to an earnings and profits pool that was also included in world-wide combined reporting income. In that case, section 25106 would apply, but a taxpayer should be ineligible for an exclusion or elimination in an amount that exceeds the amount of the distribution. See response to question 2.
8	Please clarify how the PTI and basis rules would work if a taxpayer were subject to a water's-edge election, terminated that election, and then made a new water's-edge election in a subsequent year.	Under this proposal, a taxpayer subject to a water's-edge election is entitled to the benefits of its federal PTI and federal stock basis amounts with respect to years before 01/01/2008. However, a taxpayer that terminates its water's-edge election is required to adjust its PTI and stock basis amounts to reflect only Subpart F income actually taken into account during the period of the water's-edge election (California-only PTI.) A taxpayer that returns back to a water's-edge election in a later year reacquires its federal PTI and stock basis adjustments, although there may be timing issues related to California-only PTI distributions while the water's edge-election was not in effect.
9	Can you explain the reason for the last sentence of proposed section 25117(a), dealing with business or nonbusiness income?	That sentence was added as a continuing clarification of the proposal's treatment of Subpart F income as a dividend actually paid. The business or nonbusiness treatment of the proposal's

		Subpart F income would be determined in the same manner as if the income was a dividend actually received.
10	What happens when a dividend distribution is paid from earnings and profits in excess of Subpart F income?	This proposal would use the federal ordering rules that specify that a dividend distribution is paid first from earnings and profits eligible for PTI exclusion. Any other distribution follows the normal rules for earnings and profits eligible for elimination under section 25106 or deduction under section 24411.
11	Could section 24425 expenses applied to the 27% amount of excluded Subpart F income ever exceed the actual 27% amount?	In theory, yes, although that is likely to be uncommon. This is consistent with other types of excluded income subject to the provisions of section 24425.
12	If a dividend was paid from U.S. source income earnings and profits, would the dividend receive any dividend deduction?	Federal rules prevent specified U.S. source income (generally U.S. income effectively connected with a U.S. trade or business from being included in Subpart F income. (See IRC section 952(b).) This proposal would conform to those rules. Thus, dividends paid from such earnings and profits would not be affected by this proposal and would be treated under current law. If eligible, the dividend would be eliminated under section 25106 or deductible under section 24411. Any U.S. source income included in Subpart F income under federal law would be treated under this proposal in the same manner as federal law.
13	In the calculation of the revenue estimate, was the amount of Subpart F income added to the taxpayer's sales factor denominator?	Yes. The net amount of Subpart F income (73% in accordance with FTB Legal Ruling 2006-01) was assumed to be includable in the sales factor denominator.
14	How was the 27% dividend-received deduction determined?	See attached Expanded Economic Impact.
15	Was the revenue gain that determined the 27% dividend received deduction generated because	Yes. The revenue gain is mainly the result of excluding a CFC's factors from the denominator of the apportionment formula.

	the proposal would exclude a CFC from the water's-edge combined report, including a CFC's property, payroll, and sales factors?	
16	Why does the revenue estimate use only tax year 2004 data instead of multiple tax years?	At the federal level and throughout various states, the standard approach to estimating revenue effects of proposed law changes, for official governmental estimates and those provided by private consultants, is to use only one year of data. The FTB's Economic and Statistical Research Bureau consistently adheres to this approach. For this specific proposal, the 2004 corporate sample data was used, as this was the most current and representative data at the time the estimate was initiated.
17	Is the revenue estimate provided in the proposal the same revenue estimate used by the Legislature?	If the proposal's language remains unchanged and is introduced into a bill, the revenue estimate discussed in the bill analysis prepared by FTB would be the same.
18	This proposal excludes a CFC from the water's-edge combined report, therefore, does the revenue estimate exclude intercompany transactions?	When computing the revenue estimate, we were unable to identify intercompany transactions, but feel this would have an immaterial tax effect on the revenue estimate. However, to the extent that the taxpayer adjusted the CFC income and factors to eliminate intercompany transactions, our computation accounts for these intercompany transactions.