Request for Permission to Proceed with Formal Regulation Process for A Proposed Amendment to Regulation Section 25110(d)(2)(F)3., Relating to the Deductions with Respect to Non-Effectively Connected Income

Under Revenue & Taxation Code section 25110(a)(4), a foreign corporation with less than 20 percent average U.S. factors, or a foreign bank, is included in a water's-edge combined report to the extent of its U.S. source income and factors. When regulations were first promulgated to provide guidance for this rule, the Franchise Tax Board (FTB) limited United States income to the income that is effectively connected with a U.S. trade or business (ECI) under the provisions of the Internal Revenue Code (IRC). California Code of Regulations, title 18 (CCR), section 25110(d)(2)(F)3., also stated that deductions attributable to United States income shall be determined by the allocation and apportionment rules set forth in Treasury Regulation (TR) sections 1.861-8 (other than interest expense) and 1.882-5 (interest expense).

Effective for taxable years beginning on or after January 1, 1992, the California regulations expanded the scope of United States income under the above provisions to include not only ECI, but also U.S. source business income that is not effectively connected with a U.S. trade or business (NECI). However, the FTB regulations related to the deductions attributable to United States income remain unchanged.

Under IRC section 882(a), except to the extent modifided by treaty, foreign corporations are subject to U.S. *net basis* taxation on ECI. Foreign corporations with ECI may also be subject to a branch profits tax. Under IRC section 881(a), foreign corporations' U.S. source NECI is subject to a *gross basis* tax at a flat tax rate of 30 percent unless reduced or eliminated by treaty. Therefore, there are no federal rules to determine deductions for NECI. Consequently, for federal purposes, TR sections 1.861-8 and 1.882-5 specifically do not apply in the determination of deductions for U.S. source NECI, which is taxed at gross.

Staff proposed an amendment to California Code of Regulations, title 18, section 25110(d)(2)(F)3. to provide guidance in determining the deductions attributable to non-effectively connected income of a foreign corporation that is included in a water's-edge combined report.

A symposium to discuss the proposed amendments to the existing regulation was held on February 10, 2005. A report on the symposium is included in the Board's materials. As a result of the symposium, no change was made to the language in staff's original discussion draft proposal. A copy of the proposed amendments to the existing regulation is also included in the Board's materials. Staff requests permission to proceed to the formal public hearing process under the Administrative Procedure Act.

March 29, 2005

Summary of Symposium
Discussion Draft Regulation Section 25110(d)(2)(F)3.
Deductions with Respect to Non-Effectively Connected Income

I. Background

The symposium was held at 10:00 a.m. on February 10, 2005, at the Franchise Tax Board's central office in Sacramento, California. The facilitator was John Su, Tax Counsel for the Franchise Tax Board.

The proposed amendments to the existing regulations would add provisions designed to address the manner in which deductions with respect to non-effectively connected income of a foreign corporation included in a water's-edge combined report pursuant to Revenue and Taxation Code section 25110, subdivisions (a)(4) or (a)(7)(B), are to be determined.

Prior to the symposium, staff received written comments from Joanne M. Garvey, who is with the law firm of Heller Ehrman White & McAuliffe LLP in San Francisco. On the day of the symposium, comments and suggestions were received from Barry Weissman, who is with the Irvine office of the accounting firm PricewaterhouseCoopers LLP.

In addition to Barry Weissman, Kathy Freeman with the Sacramento office of PricewaterhouseCoopers LLP, Kerne Matsubara with the San Francisco law firm of Pillsbury Winthrop, and Gary Leach of Ericsson, Inc. attended the symposium.

The symposium was also attended by Michael Brownell, Roberto Chiquillo, and Jenice Twomey of the Franchise Tax Board.

The comments and suggestions will be discussed below.

II. Written Comments

A. Joanne M. Garvey's Comments

The FTB's proposed solution may have as many problems as the present regulation. The proposal leaves unanswered:

1. How are deductions attributed to this income to be identified?

Response – Deductions attributable to non-effectively connected income are to be identified in the same manner as deductions are identified as being attributable to any other type of income. The primary means of identification is to determine if there is a factual relationship between an item of income and an expense.

Recommendation: No action required.

2. What allocation or apportionment method should be employed?

Response – The proposed amendment provides that deductions attributable to United States income that is not effectively connected with a United States trade or business shall be determined in accordance with regulation section 25120(d). Regulation section 25120(d) provides that a deduction attributable to several classes of income shall be prorated in a manner which fairly distributes the deduction among the classes of income to which it is applicable. The manner of assignment will depend on the facts and circumstances of a particular income item. Possible methods of assignment include direct tracing, a gross income ratio, an asset value ratio, or any other reasonable allocation or apportionment method.

Recommendation: No action required.

3. What, if anything, is attributed to the apportionment factors and where?

Response – Pursuant to regulation section 25110(d)(2)(F)6., the United States located apportionment factors of a corporation for purposes of subparagraph (F) shall be determined pursuant to Revenue and Taxation Code section 25120 et seq. and the regulations adopted pursuant thereto. The terms property owned or rented and used during the taxable year, compensation paid during the taxable year, sales of the taxpayer during the taxable year, and other terms defining the numerator and denominator of any factor shall be construed on a basis consistent with the determination of its United States-located income.

Recommendation: No action required.

4. How taxpayers have been reporting such income and possible deductions.

Response – The reporting methods are inconsistent among the taxpayers. For federal purposes NECI is subject to a withholding tax on a gross basis. Some taxpayers have included NECI on the same basis for state purposes and others have taken deductions against the U.S. source NECI using methods similar to those of determining the federal net ECI. This is the reason for this proposed regulation amendment, which recognizes that some deductions should be assigned to the NECI that is included in a water's-edge combined report and specifies provides the manner in which the deductions are to be determined.

Recommendation: No action required.

B. Barry Weissman's Comments

1. Regulation section 25110(d)(2)(F)1, amended by the FTB effective for taxable years beginning on or after January 1, 1992, expanded the scope of U.S. income to include not only ECI but also U.S. source business income that is not effectively connected income (NECI), is in error. To include the income of a foreign corporation in a water's-edge combined report under Revenue and Taxation Code section 25110(a)(4), the income must meet three requirements set forth in the second sentence of section 25110(a)(4). First, the income in question must be considered under federal income tax laws to be derived from or attributable to sources within the U.S. Second, such income must be determined from the books of account

maintained by the corporation. Finally, the income must be derived from "activities conducted within the U.S." The latter requirement is a further limitation of what otherwise might be considered under federal income tax laws as income derived from or attributable to sources within the U.S. U.S. source NECI is not derived from activities conducted within the U.S. Therefore, it should not be included in the water's-edge combined report. The FTB should amend the regulation to correct the error by excluding NECI from the water's-edge combined report. If NECI is not included in the water's-edge combined report, the question of how deductions with respect to NECI are determined is irrelevant.

Response – The question of whether NECI should be included in the water's-edge combined report was considered during the regulation promulgation process when regulation section 25110(d)(2)(F)1, "United States Income", was adopted. The current proposed amendments to the regulation address the question of what expenses should be assigned to such income. The question of whether NECI is properly includible is not the subject matter of the proposed amendments and Mr. Weissman's comment is beyond the scope of this amendment.

Recommendation: No action required.

2. The staff's proposed regulation amendment references another regulation, regulation section 25120(d) (which provides for proration of expenses associated with business and nonbusiness income). Regulation section 25120(d) is short of specifics as to how this proration is to be determined. Which deductions would be subject to this proration? How is the proration to be computed? Will the proration be done on a company-by-company basis or group basis? These and other questions must be answered. At a minimum, staff needs to provide examples that illustrate exactly how the proration of deductions will be done.

Response – These comments raise questions about a lack of specificity in regulation 25120(d), not the proposed amendments to section 25110(d)(2)(F)3, and overlap those of Ms. Garvey. Please see responses to Ms. Garvey's comments.

Recommendation: No action required.

III. Comments During the Symposium

Mr. Weissman reiterated his written comments during the symposium.

In addition, an attendee from the public urged the Department to provide guidance in this area as soon as possible to avoid costly compliance actions.

Section 25110 is amended to read:

§ 25110. Water's-Edge Election Group.

(a) *General*. Revenue and Taxation Code section 25110 allows qualified taxpayers to elect, subject to the provisions of Revenue and Taxation Code section 25111, to account for and determine their income derived from or attributable to California sources by considering only the income and apportionment factors of those entities specified in Revenue and Taxation Code section 25110, subdivision (a). The election may be made by a single corporation engaged in one or several businesses or by a group of affiliated corporations.

(b) *Definitions*.

(1) Corporation. Unless otherwise specified, a "corporation" is defined by Revenue and Taxation Code section 23038.

(2) Affiliated corporation. Effective for taxable years beginning on or after January 1, 1995, an "affiliated corporation" is a corporation that is a member of a commonly controlled group as defined by Revenue and Taxation Code section 25105.

(3) Business income. "Business income" is defined by Revenue and Taxation Code section 25120, subdivision (a), and the regulations adopted pursuant thereto. Business income is subject to apportionment by formula among California and the other jurisdictions where the taxpayer has a taxable presence.

(4) Nonbusiness income. "Nonbusiness income" is defined by Revenue and Taxation Code section 25120, subdivision (d), and the regulations adopted pursuant thereto. Nonbusiness income is allocated to a specific jurisdiction.

(5) Unitary business. A "unitary business" consists of those activities required to be included in a combined report pursuant to Revenue and Taxation Code section 25101 and the cases decided thereunder by the United States Supreme Court, the courts of this State, and the California State Board of Equalization. Activities constitute a "unitary business" if unity of ownership, unity of operation, and unity of use are present, or if the activities carried on within the state contribute to or are dependent upon the activities carried on without the state, or if there is a flow of value between the activities. California Code of Regulations, title 18, section 25120, subsection (b), sets forth certain indicia and standards for determining whether activities constitute a single trade or business and are therefore unitary.

(6) Water's-Edge Group. "Water's-edge group" means all corporations or other entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code Section 25110 in computing the income of the individual taxpayer for the current taxable year which is derived from or attributable to sources within this state.

(c) *Qualified taxpayer*.

(1) In general. A taxpayer is qualified to make the election provided by Revenue and Taxation Code section 25110 if it meets two conditions. First, it must consent to the taking of depositions at the time and place most reasonably convenient to all parties from certain key individuals and to the acceptance of subpoenas duces tecum requiring the reasonable production of certain documents. Second, it must agree that dividends received by all members of the water's-edge group from certain entities shall be deemed to be functionally related and presumed to be business income. (See subsection (c)(3) of this regulation.)

(2) Depositions and subpoenas duces tecum.

(A) Consent.

1. Time of making consent. The consent to the taking of depositions and acceptance of subpoenas duces tecum shall be made at the time of the filing of the tax return upon which the water's-edge election is made.

2. Period of consent. The consent shall continue in force with respect to any individual year until the taxpayer's liability for that year is finally determined and cannot be adjusted. The consent made with the water's-edge election shall be in force with respect to all years covered by that election and for which the taxpayer is required to file pursuant to Revenue and Taxation Code section 25110. The consent shall not apply with respect to taxable years for which no election was in effect.

3. Effect of consent. The granting of the consent is intended to foreclose issues of service or jurisdiction. It does not otherwise waive any defenses a taxpayer might have.

4. Information to which consent applies. The consent shall apply only to the providing of information, whether by deposition or subpoena duces tecum, necessary to review or to adjust income or deductions in a manner authorized under section 482 or Subchapter N of Chapter 1 of Subtitle A, Internal Revenue Code, together with the regulations adopted pursuant thereto, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Use of depositions and subpoenas duces tecum. The consent to the taking of depositions and acceptance of subpoenas duces tecum applies during an audit and an administrative review, including both consideration by the Franchise Tax Board and the Board of Equalization, of a taxpayer's liability under the Corporation Tax Law as well as judicial proceedings. The consent provided pursuant to Revenue and Taxation Code section 25110 is in addition to, and in no way shall expand or restrict, except as to service and jurisdiction, any rights of the taxpayer or the Franchise Tax Board which arise under the Code of Civil Procedure.

(C) Individuals subject to being deposed.

1. In general. The consent to the taking of depositions shall apply to the key employees or officers of a domestic corporation.

2. Domestic corporation. A domestic corporation is a corporation either incorporated within the United States or a corporation with an office in the United States. A corporation which has only its United States source income and apportionment factors included in a combined report pursuant to Revenue and Taxation Code section 25110, subdivisions (a)(4) and (7), shall only be considered a domestic corporation to the extent of such activities.

3. Key employee or officer. A key employee or officer is one who would be designated by the corporation at the time the request is made as among the three most knowledgeable individuals in response to a discovery request in a court proceeding, e.g., a manager, supervisor, vice president, director, etc., of a corporate or divisional department or function. The individual does not have to be located within the United States. An individual who maintains his or her office in the United States, whose activities are directed from the United States or who directs the activities of an office in the United States, may be a key domestic corporate individual. A former employee or officer may be designated; however, if such an individual will not appear to be deposed, a current employee of the taxpayer or an affiliate must subsequently be designated.

4. Time and location of deposition. The time and location at which a deposition is to be taken shall normally be subject to the agreement of the parties. If no agreement can be reached, the time and place to be designated must be the time and place most reasonably convenient to all parties including the individual to be deposed, the entities taxable in California, the employees of the Franchise Tax Board and counsel for the Franchise Tax Board. If the individual to be deposed is a resident of, or his or her headquarters is in, the United States, his or her place of residence or headquarters shall normally be the most reasonably convenient location. If the individual to be deposed is not a resident of, and his or her headquarters are not located in, the United States, the North American headquarters of the water's-edge group shall normally be a reasonably convenient location. A reasonably convenient time for such depositions shall normally occur on or before the 60th day after the mailing of the notice of deposition.

5. Review of reasonableness. Whether the time and location for a deposition is reasonable shall be subject to review at the time an action is brought to enforce or quash the notice. The determination of reasonableness is to be made by the authority from whom the request for enforcement is made.

(D) Production of documents.

1. Reasonable production. The consent to the acceptance of subpoena duces tecum shall apply only with regard to the reasonable production of documents. Documents which may reasonably be required to be produced include those under the direct or indirect control of the person subject to the subpoena duces tecum and which are relevant or material to the determination of the tax. Objections to production of documents may be made on the grounds of privilege, unreasonable burden, or lack of specificity in the description of the documents sought. The fact that documents are without the United States does not establish that their production is unreasonable. In those circumstances where it can be established that the requested documents have been moved without the United States and it appears that such documents have been removed, retained or stored outside the United States with an intent to avoid production, or it can

be established that documents without the United States are normally maintained in the United States for any period of time even though subsequently destroyed in the course of normal document retention policies, it shall be presumed production is reasonable.

2. Review of reasonableness. Whether a request to produce documents in response to a subpoena duces tecum is reasonable shall be subject to review at the time an action is brought to enforce or quash the request. The determination of reasonableness is to be made by the authority from whom the request for enforcement is made.

3. Indirect control. Documents are under the indirect control of a person when they are under the direct control of an individual who is beneath the person in a chain of command.

(3) Dividends. The agreement that certain dividends are functionally related and are presumed to be business income applies to all dividends received by any entity whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110. Dividends received from an entity whose income and apportionment factors would have been considered but for an election made pursuant to Revenue and Taxation Code section 25110 would normally be the type of dividends which are subject to the agreement. Other dividends might also be subject to the agreement. There is no negative inference to be drawn as to the classification of dividends as business or nonbusiness income as a result of the fact that they are not received from a payor described in of Revenue and Taxation Code section 25110, subdivisions (b)(2)(B)(i) and (ii).

To be subject to the agreement the dividends must be received from either:

(A) a corporation, more than 50 percent of whose voting stock is owned directly or indirectly by entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110, which is engaged in the same general line of business, or

(B) a corporation which

1. is a significant source of supply to or a significant purchaser of the output of the entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110, or

2. sells a significant portion of its output or obtains a significant part of its raw materials or input from an entity or entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110.

3. There is no requirement that more than 50 percent of the voting stock of the dividend payor be owned by entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110.

(C) For purposes of this paragraph the following definitions shall apply:

1. “Significant” means an amount equal to fifteen percent (15%) or more. The test of significance shall be applied to the purchases or sales of individual corporations and not to the water's-edge group.

2. “Source of supply” and “input” refer to the purchase of raw materials or semi-finished products for manufacturing or tangible property for resale. Amounts shall be considered cumulatively and not by category.

3. “Output” refers to the tangible property produced or sold or the service provided. Amounts shall be considered cumulatively and not by category.

4. Same “general line of business” shall have the same meaning as that provided in California Code of Regulations, title 18, section 25120, subsection (b)(1).

(d) *Application*.

(1) Affected entities. A taxpayer electing under Revenue and Taxation Code section 25110, subdivision (a), must include all entities enumerated in that subdivision and must exclude all those not described in that subdivision in the combined report utilized to compute its income derived from or attributable to sources within California. If an entity is described in any of the paragraphs of Revenue and Taxation Code section 25110, subdivision (a), it must be included even though it is not described in any other paragraph, or is described as excluded by any paragraph.

(A) Unitary requirement. Entities described in Revenue and Taxation Code section 25110, subdivisions (a)(1) through (a)(6) are all subject to the requirements of Revenue and Taxation Code section 25110, subdivision (a)(7)(A), that a unitary business relationship exists which is sufficient to require inclusion in a combined report under Revenue and Taxation Code section 25101 and the cases decided thereunder by the United States Supreme Court, the courts of this state, and the State Board of Equalization.

(B) Unitary relationship. The existence of a unitary business relationship shall be determined by reference to the relationship which exists among all affiliated corporations, not just those entities whose income and apportionment factors are required to be considered pursuant to Revenue and Taxation Code section 25110.

EXAMPLE 1. Taxpayer A is affiliated with and conducts a unitary business with B, C, D, E and F. B, C and D are incorporated in the United States. E and F are incorporated outside the United States, have no “Subpart F income,” and have no apportionment factors within the United States. If A elects the provisions of Revenue and Taxation Code section 25110, the combined report used to compute its income derived from or attributable to sources within California shall include the income and factors of B, C and D, as well as its own, and shall exclude the income and factors of E and F.

EXAMPLE 2. Taxpayer A is engaged in a unitary business with affiliate entities B, C, D, F and P. B, C and D are incorporated in the United States. F is incorporated in a foreign country, has no Subpart F income, and has no factors in the United States. P has made an election pursuant to Internal Revenue Code sections 931 through 936. All of P's payroll is in Puerto Rico, 10% of its property (inventory) is in the United States and 90% is in Puerto Rico. All of P's sales are assigned to the United States and are made to third parties. The average of P's factor in the United States is 36 2/3% (0%+ 10% + 100%/3). If A elects pursuant to Revenue and Taxation Code section 25110, the combined report used to compute its income derived from or attributable to sources within California shall include the income and factors of A, B, C, D and P. F's income and factors shall be excluded.

P shall have its income and factors included in the combined report used to compute A's income assigned to or attributable to sources within California under the requirement of Revenue and Taxation Code section 25110, subdivision (a)(2), even though it would be otherwise excluded by the provisions of Revenue and Taxation Code section 25110, subdivision (a)(3).

(2) Entities included. The following entities are includable in the water's-edge group:

(A) DISC and FSC.

1. A domestic international sales corporation (DISC) as specifically described in Internal Revenue Code section 992. In general, a DISC is a corporation incorporated under the laws of any state of the United States whose principal function is to facilitate federal tax deferral of income from export sales.

2. A foreign sales corporation (FSC) as specifically described in Internal Revenue Code section 922. In general, a FSC is organized under the laws of qualified foreign countries to make export sales. A corporation which has filed an election to be treated as a FSC but does not qualify shall not be included.

(B) Twenty percent or more.

1. In general. Any corporation whether organized in the United States or a foreign country, if the average of its property, payroll and sales factors within the United States is 20 percent or more. For purposes of subsection (d)(2)(B) of this regulation, the term corporation does not include a bank.

2. Absence of factor(s). For purposes of computing the average of its factors within the United States, if an individual corporation does not on a worldwide basis have one or more of the factors of property, payroll or sales, that factor shall be disregarded in computing the average of its factors within the United States.

EXAMPLE: Taxpayer A is affiliated with and conducts a unitary business with F, an entity incorporated outside the United States. F has no payroll either within or without the United States. Therefore, for purposes of determining if F has 20% or more of its factors within the

United States, it looks only to the average of its property and sales factors and no weight is given to a payroll factor.

3. U.S. factors. For purposes of computing its total property, payroll or sales factors within the United States, an individual corporation shall sum the percentage calculated for each factor under the rules of each of the individual states as set forth herein. Throwback sales are to be included in calculating the sales factor to the extent required under the applicable law subject to the provisions of subsections (d)(2)(B)3.d. and e. of this regulation.

a. States with taxes. For those states which assess a tax on, according to or measured by income and in which the corporation has a factor located in the state within the meaning of the law and regulations of that state, the corporation shall compute the percentage for each such factor under the rules of that state without regard to whether or not it files a return with the state or is taxable under the laws of the state.

b. States without taxes or factors. If a corporation has property, payroll or sales assignable to a state which does not impose a tax on, according to or measured by income or which assigns income on the basis of an apportionment formula which does not utilize each of such factors, the amount assignable to a state of any factor not used by such state shall be determined pursuant to the rules set forth in Article 2 of this Chapter 17, Revenue and Taxation Code, and the regulations adopted pursuant thereto.

c. Non-uniform states. In those circumstances where property, payroll or sales are not defined in a substantially uniform manner by the individual states, the taxpayer may elect to compute the property, payroll or sales assignable to any individual state pursuant to the rules set forth in Article 2 of Chapter 17, Revenue and Taxation Code, and the regulations adopted pursuant thereto.

d. Sales to affiliates. In computing the sales factor, sales made by the corporation to a member of the water's-edge group of which it is an affiliate shall not be taken into account in computing either the numerator or denominator of the sales factor for such corporation.

e. No item of property, payroll or sales shall be assigned in total to more than one state. The taxpayer shall determine to which of several states an item shall be assigned.

(C) U.S. incorporated. Any corporation, regardless of the location of its property, payroll and sales, more than 50 percent of whose stock is controlled, directly or indirectly, by the same interests and which is incorporated in the United States, except for a corporation making an election pursuant to Internal Revenue Code sections 931 to 936.

(D) Export trade. An export trade corporation as defined in Internal Revenue Code section 971. In general, an export trade corporation is a corporation organized in a foreign country, whose combined voting stock and total value of stock is more than 50 percent owned by

United States shareholders, and which derives 90 percent or more of its gross income from without the United States of which 75 percent or more is from export trade.

(E) Subpart F. Any controlled foreign corporation as defined in Internal Revenue Code section 957, which has Subpart F income. In general, a controlled foreign corporation is one organized in a foreign country, whose stock is owned more than 50 percent by United States shareholders.

1. Subpart F income. Subpart F income is defined in Internal Revenue Code section 952. In general, Subpart F income consists of foreign base company income which is income arising from the manufacture or the sales of goods and services outside the country in which the corporation is organized. There are numerous other types of Subpart F income described in Internal Revenue Code section 952 et seq. Each and every such item of income is Subpart F income for purposes of this subsection. In determining Subpart F income for a given year the limitation and recharacterization provisions of Internal Revenue Code section 952(c) shall not apply. Subpart F income does not include income defined in Internal Revenue Code section 956.

2. Amount included. The includable amount of the income and apportionment factors of such entity shall be determined by multiplying the total income and each numerator and each denominator of each apportionment factor of such entity by a fraction, the numerator of which is the total Subpart F income of such entity for the year and the denominator of which is the earnings and profits as defined in Internal Revenue Code section 964 for such year. If there are no earnings and profits for the current year, none of the income and factors of the entity shall be included. The fraction so determined shall not exceed one and shall not be less than zero.

3. Special rules. In determining whether a corporation has Subpart F income for purposes of this section, the limitation and exclusions provided for in Internal Revenue Code section 954(b) shall apply.

EXAMPLE: Corporation CFC, a controlled foreign corporation, has foreign base company income of $5,000 and total gross income of $110,000. Corporation CFC does not have Subpart F income because under Internal Revenue Code section 954(b) it is treated as having no Subpart F income when such income is less than 5% of its total income.

4. Calculation. For purposes of computing the fraction under subsection 2., above, Subpart F income and earnings and profits include both business and nonbusiness income as defined under Revenue and Taxation Code section 25120. The fraction so computed shall apply for purposes of determining the total income to be included in the combined report and all of the components of total income. Thus, the fraction applies to determine the net business income subject to apportionment by formula, the nonbusiness income subject to allocation, the interest expense subject to the foreign investment interest offset under, Revenue and Taxation Code section 24344, and all other items of income or expense which may be needed to be included in computations in the combined report. Application of the fraction shall not result in

changing the character of any item of income or expense from business to nonbusiness or from nonbusiness to business.

EXAMPLE: Corporation F has a ratio of Subpart F income to earnings and profits of one-fourth "1/4". Both Subpart F income and earnings and profits include business and nonbusiness income. Corporation F has total income of $1,600, including net business income of $1,000 and nonbusiness dividends of $600 allocable to its domicile in a foreign country. Net business income includes a deduction for interest expense of $200. Corporation F has no interest income. Amounts includable in the water's-edge combined report for Corporation F are computed as follows:

Business income subject to apportionment, $1,000 x 1/4 = $250.

Nonbusiness dividends allocable outside California, $600 x 1/4 = $150.

Interest expense, $200 x 1/4 = $50.

(F) Other entities. Any foreign organized corporation not described in subsections (d)(2)(A) through (D) of this regulation, shall have its United States located apportionment factors and income included in the combined report.

1. United States income for taxable years beginning on or after January 1, 1992.

a. Effectively Connected. The United States income of such a corporation includes (a) that income which is effectively connected, or treated as effectively connected under the provisions of the Internal Revenue Code, with a United States trade or business and (b) that United States source income which is not effectively connected with a United States business if such income is considered business income under Revenue and Taxation Code section 25120 and the regulations thereunder. The source of such United States income shall be determined in accordance with the sourcing rules of the Internal Revenue Code such as those set forth in sections 861 through 865 and subsections (g) and (h) of section 897, and the regulations adopted pursuant thereto. Foreign source income which is considered effectively connected to a United States trade or business pursuant to Internal Revenue Code section 864(c)(4)(B), and thereby subject to federal income tax, is deemed derived from or attributable to sources within the United States and is included in the combined report. Provisions of United States treaties to the extent they limit the application of effectively connected provisions of the Internal Revenue Code shall not be followed. Income excluded from United States federal income tax pursuant to the provisions of Internal Revenue Code section 883 shall be excluded from income in the combined report of an electing group for purposes of Revenue and Taxation Code section 25110.

b. Not effectively connected. The United States income of such or corporation does not include income which is not effectively connected or treated as effectively connected with a United States trade or business regardless or whether or not it is treated as

United States source income pursuant to the Internal Revenue Code, if such income is considered nonbusiness income under Revenue and Taxation Code section 25120 and the regulations thereunder.

2. United States income for ~~For~~ taxable years beginning before January 1, 1992.

a. Effectively connected. The United States income of such a corporation includes only that income which is effectively connected, or treated as effectively connected, under the provisions of the Internal Revenue Code, with a United States trade or business. The source of such United States income shall be determined in accordance with the sourcing rules of the Internal Revenue Code such as those set forth in sections 861 through 865 and subsections (g) and (h) of section 897, and the regulations adopted pursuant thereto. Foreign source income which is considered effectively connected to a United States trade or business pursuant to Internal Revenue Code section 864(c)(4)(B), and thereby subject to federal income tax, is deemed derived from or attributable to sources within the United States and is included in the combined report. Provisions of United States treaties to the extent they limit the application of effectively connected provisions of the Internal Revenue Code shall be followed. Income excluded from United States federal income tax pursuant to the provisions of Internal Revenue Code section 883 shall also be excluded from income in the combined report of an electing group for purposes of Revenue and Taxation Code section 25110.

b. Not effectively connected. The United States income of such ~~or~~a corporation does not include income which is not effectively connected or treated as effectively connected with a United States trade or business regardless of whether or not it is treated as United States source income pursuant to the Internal Revenue Code.

3. Deduction. Deductions attributable to United States income that is effectively connected, or treated as effectively connected with a United States trade or business as described in subsections (F)(1)(a). and (F)(2)(a), shall be determined by the allocation and apportionment rules set forth in Treasury Regulation sections 1.861-8 (other than interest expense) and 1.882-5 (interest expense). Deductions attributable to United States income that is not effectively connected with a United States trade or business as described in subsection (F)1.a. shall be determined in accord with California Code of Regulations, title 18, section 25120, subsection (d).

4. California taxable income. The net income included in the combined report shall be determined pursuant to the Revenue and Taxation Code.

5. Taxable. For purposes of this subparagraph a United States trade or business consists of activities sufficient to make the corporation taxable in a state as defined in Revenue and Taxation Code section 25122 and the regulations adopted pursuant thereto. A corporation may be taxable in a state regardless of whether or not it is considered to have a permanent establishment in the United States pursuant to a treaty entered into between the United States and the country in which the corporation is organized or has its principal place of business.

EXAMPLE 1. Corporation F, an organized foreign corporation, has less than 20% of the average of its property, payroll and sales factors within the United States. F has U.S. source income of ($100,000) including an ACRS depreciation deduction of $200,000. F's U.S. source income determined under California rules is $25,000 because California does not follow the ACRS depreciation system and allowable California depreciation is only $75,000. The amount of $25,000 shall be included in the combined report required under Revenue and Taxation Code section 25110.

EXAMPLE 2. Corporation F, a foreign corporation with a business office in the U.S., is engaged in the business of licensing patents, some of which it has either purchased or developed in the U.S. Licenses for the use of the U.S. developed patents outside the U.S. are negotiated by F's U.S. office. The royalties received from such foreign licenses is foreign source income considered effectively connected income attributable to F's business office in the U.S. and shall be included in the combined report required under Revenue and Taxation Code section 25110.

EXAMPLE 3. Corporation F, a foreign corporation, has a branch office in California where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. The corporation has U.S. gross sales of $1,000,000 and a cost of goods sold to the U.S. branch of $700,000. (Determined pursuant to Internal Revenue Code section 863, and the regulations adopted thereunder.) Excess funds generated by F's U.S. business activities are invested in publicly traded securities issued by domestic corporations. F plans to use these excess funds to expand its U.S. facilities within the next three years. In the current year, the branch office derives from U.S. sources dividend income in the amount of $200,000 on these securities, and incurs expenses of $50,000 in managing the investment portfolio. For federal purposes, the dividends received from the investment in the securities is considered effectively connected with the conduct of its U.S. trade or business. (Treasury Regulation~~s~~ section 1.864-4(c)(2)(iii)(B).) The dividends are considered U.S. source income for purposes of Revenue and Taxation Code section 25110, subdivision (a)(4).

For California purposes, $450,000 (gross receipts of $1,200,000 less expenses of $750,000) shall be included in the combined report required under Revenue and Taxation Code section 25110.

EXAMPLE 4. Corporation S is a corporation, domiciled in and organized under the laws of a foreign country, which is engaged in the operation of aircraft or a ship or ships and which has less than twenty percent of the average of its factors within the United States. The income of S, which is described in Internal Revenue Code section 883 and is therefore excluded from United States taxation, and the apportionment factors attributable thereto shall not be included in the combined report required under Revenue and Taxation Code section 25110.

6. U.S. apportionment factors. The United States located apportionment factors of a corporation for purposes of this subparagraph and paragraph (3) of this subsection shall be determined pursuant to Revenue and Taxation Code section 25120 et seq. and the regulations adopted pursuant thereto except that the terms property owned or rented and used during the taxable year, compensation paid during the taxable year, sales of the taxpayer during

the taxable year, and other terms defining the numerator and denominator of any factor shall be construed on a basis consistent with the determination of its United States located income.

(G) Choice of E or F. The United States income and apportionment factors of a foreign corporation which is not an electing taxpayer and which could be included in a combined report pursuant to both subsections (d)(2)(E) and (F) of this regulation shall be determined under subsection (d)(2)(F) and not under subsection (d)(2)(E).

(3) Non-described entities. Any corporation which is a taxpayer which has made a water's-edge election and which is not described in subsections (d)(2)(A) through (d)(2)(D) of this regulation shall determine its income derived from or attributable to sources within California on the basis of its United States located apportionment factors and income and the income and apportionment factors of the other entities included in the water's-edge group of which it is a member. (For a definition of factors within the United States see clause (ii) of subparagraph (G) of paragraph (2) of this subsection.)

(e) *Intercompany accounts*. California Code of Regulations, title 18, section 25106.5-1, shall apply to intercompany transactions that occur in taxable years beginning on or after January 1, 2001. Prior versions of this regulation shall apply to intercompany transactions occurring in taxable years beginning before January 1, 2001.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25110, Revenue and Taxation Code.