Request for Permission to Proceed with the Formal Regulatory Process to Adopt A Proposed Amendment to Regulation Section 25110(d)(2)(F)3., Relating to Deductions with Respect to Non-Effectively Connected Income, And Recommendation to Deny the Petition Filed by OFII to Amend Regulation 25110

Background

Non-Effectively Connected Income (NECI) is income derived from the United States that is received by foreign corporations that either do not engage in a trade or business in the United States, or the income is not attributable to the conduct of the foreign corporation's trade or business in the United States. In most circumstances this income is received from United States entities that are related to the foreign corporations. Examples of this type of income are royalties from licensing patents for use in the United States and interest received on loans to United States borrowers. NECI is taxable by the United States even though the foreign recipient is not otherwise taxable in the United States and is reported to the United States without allowing for a deduction of expenses related to such income. NECI is frequently dealt with in bi-lateral United States Tax Treaties by providing that such income will be taxed at a rate significantly lower than the nominal federal income tax rate.

Because NECI is United States source income, staff believes it is includible in a water's-edge combined report. When regulations were first promulgated under the water's-edge election, a decision was made to exclude NECI because of difficulties in obtaining information with regard to NECI. Subsequently, federal reporting requirements were adopted that allowed staff to determine the amount of NECI. The water's-edge regulations were amended to provide for the inclusion of NECI in 1992. California computes its tax on the basis of "net business income." Because NECI is reported as gross income an adjustment needs to be made to arrive at net income. Staff has proposed amending the regulation to describe how to determine the deductions that will be allowed to arrive at a "net" NECI amount.

The Organization for International Investment (OFII) has petitioned the Board to adopt a regulation that would remove income from intangibles from the water's-edge combined report if it is either 1) received from an unaffiliated corporation or 2) received from an affiliate and the recipient is either a) subject in a foreign country to tax on such income; b) it is a flow-through of an expense the recipient has; or 3) the contract is at arm's-length.

History

On **June 10, 2004**, the Board authorized the staff to hold a symposium to discuss proposed amendments to Regulation 25110(d)(2)(F)3. to describe what deductions would be allowed with respect to NECI to compute net income for purposes of a water's-edge combined report.

The symposium was noticed on December 1, 2004 and held on **February 10, 2005**.

A report on the symposium was made to the Board at its meeting of **March 29, 2005,** and staff was directed to work with interested parties to develop examples to illustrate how the proposed amendments would work.

A second symposium was held on **May 23, 2005**. Staff prepared proposed examples which illustrated application of the proposed amendments. Suggestions offered by the public at the symposium describe circumstances in which various items of income would not be included in a water's-edge combined report. No suggestions were offered for examples to illustrate how deductions would be computed to arrive at a net income figure.

Staff reported to the Board at its meeting of **September 7, 2005**, that it was still working with members of the public to develop examples.

On **October 25, 2005**, staff met with representatives of OFII, including Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP, to discuss proposed amendments. OFII had not participated in the previously held symposia. OFII took the position that NECI should not be included in a water's-edge combined report. Staff advised OFII that it believed that NECI should be included and was looking for a method and examples that would give rise to the correct calculation of net income.

On **January 1, 2006**, OFII submitted a copy of the Illinois "add-back" statute. An add-back statute is one that denies a deduction with respect to an otherwise allowable expense incurred by one entity that is paid to a related entity. It is viewed as an anti-abuse safeguard. Its principal components are: 1) to allow a deduction in those circumstances where the entity to which the payment is made is flowing through a cost that it has incurred; and 2) to only trigger the add-back when it can be shown that the charge was not on an arm's-length basis and was made with a tax avoidance motive.

Staff reviewed the Illinois statute and determined that while it denied a deduction rather than addressing the calculation of net income, it did contain concepts that could be utilized in calculating net income. For example, the Illinois statute provides that there would be no add-back if the party receiving the payment was passing through a cost it had paid to an unrelated party.

On **April 27, 2006**, OFII supplied proposed amendments based upon the Illinois statute.

Staff prepared proposed language based on the Illinois statute to OFII on **May 19, 2006**. Staff's proposed language specifically states that any amounts paid to an unrelated third-party which were passed through to the United States entity would be allowed as a deduction. The add-back statute also does not operate unless the tax administrator can show that the payment was not at an arm's-length price. Staff attempted to include this concept by including an amendment that expenses in excess of NECI would be allowed only if the taxpayer showed that they were incurred at an arm's-length price and not with a principal purpose of tax avoidance.

Another meeting was held with OFII on **June 12, 2006**. OFII indicated that it did not find staff's proposed amendments acceptable. Staff explained its position and its goal of arriving at a net income figure without creating excessive administrative burdens for the taxpayer or for our audit staff. Staff requested OFII to submit an alternative proposal that attempted to arrive at net income. Staff indicated it would be receptive to any proposal that would arrive at net income without creating either a compliance or auditing burden. Staff indicated that any proposal based upon the state accepting whatever expenses were allocated subject to a review of whether they reflected an arm's-length value would be unadministerable.

In **July, 2006**, staff suggested in a telephone call that a possible solution might be to include a safe-harbor clause in the proposed regulation. That is, in lieu of making a specific allocation of expenses, it might be acceptable to allow a deduction equal to some percentage of the NECI to arrive at net NECI.

In **August, 2006**, OFFI responded by telephone that it had no alternative to offer.

On **August 22, 2006**, the firm of Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP submitted a petition under the Administrative Procedures Act to the Chair of the Franchise Tax Board asking for an amendment to exclude from the definition of "United States income" certain types of "not effectively connected income" as well as income which is effectively connected but not subject to inclusion pursuant to U.S. treaty terms. Staff's response to that petition is attached.

<u>Recommendations</u>

Staff recommends that the Board request that the petitioners grant an extension of time to respond to their petition until shortly after the next meeting of the Franchise Tax Board. This will allow the petitioners and staff to continue to try and see if they can reach a resolution. Staff believes that both the petitioners and staff recognize that the same problem currently exists, but only differ as to what the correct solution is.

Alternatively, if the petitioners are unwilling to grant an extension of time, staff recommends that the petition be denied by the Board in light of the efforts currently underway to address the problem, or that the petition be referred to the Executive Officer for action.

If the petition is denied by the Board, staff recommends that the Board authorize it to proceed by formally noticing its proposed amendments under the APA. After a public APA hearing is held on the proposed amendments, staff would report back to the Board on the hearing for further direction or consideration of adopting the proposed amendments as they may be changed as a result of the hearing. Petitioners would of course be able to participate in the hearing process.

<u>Reasons Supporting Recommendations</u>

Some action must be taken on the petition unless the petitioners are willing to grant an extension due to the time constraints imposed by the Administrative Procedures Act.

If petitioners refuse to grant an appropriate extension, staff recommends that OFII's proposed amendments be denied. Staff believes the proposed amendments would create an un-level playing field that could provide an advantage to the subsidiaries of foreign corporations.

Staff recognizes that a problem exists and initiated the regulatory process to address that problem. A solution is needed. Staff has met with interested parties in an attempt to resolve differences. The Board's approved process of holding symposia and working with interested parties has resulted in changes to staff's proposed amendments. Attached is a draft that reflects those modifications that have already been made available to interested parties. That draft includes specific examples per the direction of the Board and adapts language contained in the Illinois statute for use in the calculation of net income.

In addition, the proposed draft contains an additional modification which establishes a safe harbor in lieu of proving specific deductions. The possibility of this proposed modification was communicated to OFII, but the specific language of the modification has not previously been made public. Staff's proposed amendments address the problem of making sure that subsidiaries of domestic and foreign parent corporations are treated identically. The public should be given an opportunity to review and respond to staff's new proposed amendments.

ATTACHMENT

STAFF RESPONSE TO OFII PETITION OF AUGUST 22, 2006

The Organization For International Investment (OFII) has petitioned this Board to amend Regulation section 25110(d)(2)(F)(1) to exclude from the definition of "United States Income" certain types of "not effectively connected income" (NECI) as well as income which is effectively connected but not subject to inclusion pursuant to U.S. treaty obligations (copy attached). A draft of the proposed amendments to the regulation was included with the petition. The petition also had attached a two-page statement of arguments in support of the need for a regulation (copy attached).

OFII requested that this matter be scheduled for public hearing at the Board's September meeting.

Under the Administrative Procedures Act (APA), the Board cannot hold a hearing on the proposed amendments, per se, as they have not been properly noticed. The Board can consider whether it should direct staff to notice the proposed amendments, deny the petition, or take no action. In the event the Board takes no action, the Executive Officer, pursuant to the Board's delegation of authority, will take action on the petition within the time period specified in the APA.

The Board cannot, on its own, extend the time period specified in the APA to act upon the petition. The petitioner, however, can grant an extension of time.

Staff Response to Arguments Offered in Support of the Proposed Amendment

OFII states that the regulation as currently applied:

1) makes it more expensive to borrow money or license technology from their corporate parent than from unrelated third parties;
2) discourages foreign investment;
3) breaks both the spirit and purpose of the Water's-Edge Election; and
4) discriminates against foreign companies.

Staff disagrees with each of the arguments advanced in support of the proposed amendments.

Initially it should be noted that the current regulation is silent with respect to the manner of determining the amount of expenses that can be allocated to NECI. For a number of years there was little or no controversy with respect to the allocation of expenses to NECI. Within the last several years the audit staff has encountered situations where they believed taxpayers were overstating the amount of expenses attributable to such income. As a result the audit staff has begun to request taxpayers to provide support for the amount of expenses they have claimed. If the taxpayer does not provide support the auditor, in some, but not all, cases has been denying a deduction for any expenses. Staff agrees that taxpayers should be entitled to deduct the expenses related directly or indirectly to this income. Staff proposed amendments to the regulations to provide guidance to both taxpayers and the audit staff as to how to determine the amount of expenses that would be allowed as a deduction. There are several cases where expenses have been disallowed that have been deferred pending resolution of this issue. Staff believes when OFII refers to the "current application of the regulation" they are referring to circumstances where no expenses relating to NECI have been taken into account and staff's response is based on that assumption.

1. The Current Application of the Regulation Makes It More Expensive to Borrow or License from Corporate Parent than Unrelated Parties

OFII claims the current regulation as applied encourages U.S. subsidiaries to borrow money or license technology from unrelated third parties because it increases their expenses, thereby reducing overall taxable income.

The current regulation does not increase expenses. The same expense deduction of the United States organized entity is allowed regardless of whether it is paid to a third party or an affiliate.

The current regulation does include in the combined report the income received by an affiliate as a result of the payment. However if the recipient is included in the water's-edge combined report the payer's deductible interest or royalty expense is offset by the income of the recipient. An unrelated party that receives such income would also have US source income subject to tax, but the income would not offset the payer's expense. OFFI's argument ignores the fact that if a payment is made to a third-party, rather than to an affiliate, it will reduce the income of the unitary business. A foreign parent is unlikely to encourage its United States subsidiary or affiliate to engage in transactions with third parties, thereby decreasing the overall income of the unitary business.

To the extent the current regulation is silent with respect to the allowance of expenses against NECI and no expenses are claimed or allowed against such income, it may result in an increase in net income. Staff's proposed amendments are intended to correct this interpretation and eliminate any potential discrimination.

2. The Current Application of the Regulations Discourage Foreign Investment

OFFI claims the current regulation treats third-party financing more favorably than direct foreign investment**.** This is an inappropriate comparison. Financing as compared to direct investment are two different situations. Financing involves the payment of interest and interest is deductible. A return on direct investment is generally received through the payment of dividends and dividends are not deductible. In other words financing gives rise to a deductible expense while direct investment does not.

3. The Current Application of the Regulation Breaks The Spirit and Purpose of the Water's-Edge Election

Prior to the enactment of the Water's-Edge Election, California used the worldwide combined reporting method for a unitary business to ascertain the amount of income derived from or attributable to sources within this state. California's use of this method drew complaints by foreign nations to the United States. The constitutionality of this method was sustained in *Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, and *Barclays Bank PLC v. Franchise Tax Board* (1994) 512 U.S. 298. As a result of the *Container* decision the federal government convened a "working group" to see if a solution could be reached to address the concerns of foreign governments and the states. The result of that "working group" was the water's-edge election provisions. These were adopted, with modifications, by California in 1986.

OFII states that "[u]nder the 'Waters Edge election, a taxpayer must include in their unitary or combined group those affiliated corporations within the 'water's-edge' of the United States. This was generally thought to reflect the scope of taxation under federal income tax laws." This statement is correct but OFII fails to recognize that the federal government does tax foreign-organized entities, including their NECI.

Under "Water's-Edge" the states agreed not to assert their right to consider the income of foreign organized entities that was not taxed by the federal government in determining the amount of income attributable to activities in their state. However, the states were concerned that if they did not have some mechanism to include income earned by foreign entities in the water's-edge, they would become the victims of abusive tax strategies. As a result the states determined that their interests could be protected if they relied upon the federal government because it also has an interest in seeing that foreign-based entities pay a tax on their income from United States sources. The fact that the states retained the right to consider the income of foreign entities taxed by the federal government is demonstrated by the inclusion of 1) Subpart F income in the water's-edge combined report, 2) the income of entities wherever organized that are doing more than twenty percent of their business in the United States, and 3) the United States source income of foreign entities.

The spirit and purpose of the water's-edge election was to allow the states to consider all of the income considered by the federal government in determining the amount of income attributable to activities within their boundaries. The consideration of United States source income and NECI fulfills this purpose. The United States taxes NECI without allowing expenses. For California purposes the tax is measured by "net income" so expenses should be allowed. The staff's proposed solution is to provide a means for determining the proper expense deduction related to the income, not to remove income from the base, which is what the OFII proposal would do.

The Worldwide Unitary Taxation Working Group, chaired by then Secretary of the Treasury, Donald T. Regan, developed guidelines for the formulation of state tax policy. Those guidelines eventually led to the California water's-edge legislation. While the Working Group members, including state and business representatives, were unable to reach agreement on a specific approach, the Working Group agreed on three principles that should guide state taxation of the income of multinational corporations:

> Principle One: Water's-edge unitary combination for both U.S. and foreign based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

Under Principle Three, state tax policy should maintain competitive balance among all business taxpayers, including foreign multinationals, U.S. multinationals, and purely domestic businesses. Individual states should avoid harming U.S. firms by any actions that would place U.S. business at a competitive disadvantage relative to its foreign competitors. Similarly, purely domestic business should not be harmed by any state tax policy that treats any multinational more favorably than a U.S. business with no foreign operations. State tax policy, in other words, should not discriminate between U.S. and foreign firms, or between U.S. firms with and without foreign operations.

OFII's argument is a misapplication of Principle Three. In OFII's scenario, both a domestic third party and the U.S. subsidiary can deduct royalties paid to a foreign entity. The difference is the U.S. subsidiary is required to include the royalty income of the related foreign entity in the combined report as is the U.S. subsidiary of a domestic parent. The domestic third party may deduct the royalties paid, but the foreign payee then has reportable NECI. The same result is accomplished on two returns rather than one.

What is important is that, when receiving royalty income from a subsidiary, the water's edge combined report must not favor foreign business over domestic business. If the royalty income received by a foreign entity is excluded from a combined report while it is included when received by a domestic entity, the practice violates Principle Three. The existing regulation, as it was initially applied, and as staff's proposed amendments provide for, avoids this competitive imbalance among foreign multinationals, U.S. multinationals, and pure domestic businesses.

<u>4. The Current Regulation, As Applied, Discriminates Against Foreign Companies</u>

Under the unitary method the income and expenses of all members of a unitary business are "combined" and an apportionment formula reflecting all of the activities of the unitary business is applied to the combined income to determine the amount attributable to a state.

Consider the case of a parent company that owns a patent that it licenses to its subsidiary. If the parent company is a United States company it earns income from the receipt of the royalty payment and the subsidiary incurs an expense in paying the royalty. The parent company is allowed a deduction for expenses related to the patent. All of this is taken into account in the combined report.

If the parent company is a foreign-based company and it charges a royalty to its United States subsidiary, the parent earns royalty income that could be NECI and the subsidiary incurs a royalty expense. If the NECI is not included in the combined report the United States subsidiary is at an advantage to a comparable company with a domestic parent because there is no offsetting income item. If the NECI is included the subsidiary corporation is in exactly the same position regardless of whether its parent is foreign or domestic. In both cases an expense is offset by income.

Change the example and suppose the royalty is paid to an unrelated third party. In that example the entity paying the royalty is allowed a deduction and there is no offsetting income item because the recipient of the royalty is not included in the combined report. It doesn't matter whether the recipient is domestic or foreign. The recipient may be taxable by the state on the royalty income it receives, but that is dependent on the connections the recipient has with the taxing state.

In both cases there is a parity of treatment. There is no discrimination under the existing regulation as it had been applied, and as staff's proposed amendments would require it to be applied. In fact the treatment being sought by OFII, elimination of NECI income, results in discrimination in favor of the U.S. entity that pays NECI to a foreign affiliate.

In the case of the foreign parent there may be discrimination if the parent is not allowed to take a deduction with respect to the expenses it incurs. That is precisely the circumstance staff's proposed amendments seek to address in order to provide certainty that the foreign parent will be allowed a deduction for its expenses.

<u>Other arguments</u>

OFII states that the FTB proposal "may ignore U.S. treaty obligations." As the United States Supreme Court pointed out in *Barclays*, U.S. treaties by their terms generally do not apply to subnational taxes. There is an exception with respect to non-discrimination clauses. Including U.S. source income in state income tax calculations does not violate any U.S. treaty obligations.

It ignores the fact that the income of the foreign parent is likely taxed in a foreign jurisdiction. The issue of "multiple taxation" was addressed by the United States Supreme Court in *Container* and *Barclays*. The federal government taxes this income with the same effect. In international taxation the jurisdiction of residence can tax all the income of a domiciliary but international practice is to give a tax credit for source based taxation. That is what the taxation of NECI is.

It treats lending and licensing transactions differently than other inter-company transactions (sales between related entities are excluded from the sales factor numerator and denominator) This is true but they are different. Sales of tangible goods may be more easily audited and adjusted.

The state should only use this proposal to remedy tax avoidance situations as other states have done through the use of add-back statutes. Staff agrees add-back statutes would be one way to deal with the problem, but it does it in a backwards manner by disallowing an otherwise allowable expense. These statutes also typically put the burden on the tax agency to show that transactions were not at arm's-length, a problem combined reporting was originally proposed to avoid.

For technology owned by a foreign affiliate and for which no reasonable alternative is available a domestic third party licensee will have a competitive advantage over a related party licensee because the third party can deduct the expense without a recovery of the income. But this ignores the fact that the third party will also have a tax liability and that the foreign parent will lose a source of income. The disadvantage arises if the affiliate is not allowed a deduction for expenses properly allocable to the income. This is the problem the staff's proposed amendment is attempting to resolve.

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. If not connected with the conduct of a trade or business within the United States, holding stock shall not be treated as an activity conducted within the United States for purposes of Revenue and Taxation Code section 25110, subdivision (a)(4). 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~~a 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.

a. 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, 1.861-8T (other than interest expense), and 1.882-5 (interest expense).

b. 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) as described in subparagraphs (i) and (ii) of this subsection.

(i) The deductions allowed shall be the total of direct expenses and indirect expenses as determined herein, allocable to each item of not effectively connected income, except that a deduction in excess of the amount of each item of not effectively connected income included in the combined report shall be allowed only to the extent, and in an amount, the taxpayer demonstrates that direct expenses in excess of such item of income that is not effectively have been paid, accrued or incurred at an arm's-length rate and not with a principal purpose of tax avoidance.

a. Expenses directly traceable to non-effectively connected income included in a combined report will be allowed as deductions in computing net income included in the combined report. Expenses paid, accrued, or incurred to an entity that is not an affiliated corporation with respect to the non-effectively connected income included in the combined report shall be considered to be directly traceable.

b. Indirect expenses, other than interest, shall be allocated to non-effectively connected income by an appropriate method. The taxpayer is free to choose among allocation methods recognized by United States Generally Accepted Accounting Principles for deducting indirect expenses in filing its original California tax return for the first taxable year beginning on or after the effective date of these amendments. Where applicable, and if they result in a fair reflection of net income, the allocation and apportionment rules set forth in Treasury Regulation sections 1.861-8 and 1.861-8T (other than for interest) may be followed. If the taxpayer attempts to use a different method in subsequent years, the burden is on the taxpayer to show why a change in method is appropriate and that such a change fairly reflects net income on an ongoing basis.

c. Indirect interest expense shall be allocated using an asset-based allocation method. Assets shall be valued at book value net of applicable depreciation, depletion, and amortization.

ii. In lieu of the deductions calculated pursuant to paragraph (i) of this subsection, a deduction equal to ________ percent (__%) of the amount of non-effectively connected income included in the water's-edge combined report shall be allowed as properly allocable to such income.

Examples

Corporation A is a California taxpayer and is the 100 percent owned United States subsidiary of foreign corporation P. P has United States source income that is not effectively connected with the conduct of a trade or business within the United States. Corporation A, together with its United States subsidiaries, and Corporation P are engaged in a unitary business. A made a water's-edge election and files its California return on a combined report basis including its United States subsidiaries. In addition, pursuant to California Corporation Tax Law section 25110, subdivision (a)(4), and California Code of Regulations, Title 18, section 25110(d)(2)(F)1.a.(b), A must include P's net income derived from or attributable to sources within the United States in A's water's-edge combined report.

Under California Code of Regulations, Title 18, section 25110(d)(2)(F)3, expenses attributable to a foreign corporation's United States source business income that is not effectively connected with a United States trade or business are deductible against such income. The expenses shall be fairly prorated and distributed to the foreign corporation's income that is included in a water's-edge combined report in accord with California Code of Regulations, Title 18, section 25120(d).

(a) P is a licensee under a licensing agreement with an unrelated foreign corporation X. Pursuant to the terms of the licensing agreement, for an annual fee of $300,000, P is authorized to use X's trademark in the United States. P entered into a trademark agreement with A, authorizing the use of X's trademark in the United States by A and A's United States subsidiaries for an annual royalty fee of $1 million. The gross receipts of the $1 million royalty fee constitute business income of P sourced to the United States that is not effectively connected with a United States trade or business under the Internal Revenue Code.

To compute the net royalty income that must be included in the water's-edge combined report, P may deduct the $300,000 it pays to X as a direct expense against the $1 million royalty receipts. In addition, P is able to establish a factual relationship between its general and administrative expenses and the $1 million United States source royalty fee. An allowable indirect expense deduction against the $1 million royalty receipts shall be determined by applying a ratio, the numerator of which is the $1 million United States source royalty fee and the denominator of which is P's gross income after deducting its cost of goods sold, to P's total general and administrative expenses. A deduction in excess of $1 million will not be allowed unless it can be shown that the expenses were paid, accrued or incurred at an arm's length rate and were not paid, accrued, or incurred with a principal purpose of tax avoidance.

A deduction in excess of $1 million.

(b) P received $600,000 interest from A, A's United States subsidiaries, and unrelated 3rd parties in the United States on accounts receivable due to P. The $600,000 interest constitutes business income of P sourced to the United States that is not effectively connected with a United States trade or business under the Internal Revenue Code which must be included in the water's-edge combined report.

P identified and established that $200,000 interest expense it incurred is directly and exclusively attributable to the $600,000 interest income. To compute the net interest income that must be included in the water's-edge combined report, P may deduct the $200,000 interest expense it incurred as a direct expense against the $600,000 interest receipts. There are no other expenses directly traceable to the $600,000 interest received from the payors in the United States. Because money is fungible, a reasonable amount of P's interest expense may be allocated to, and is deductible against, P's United States source interest receipts. P is allowed to deduct a portion of its interest expense, other than the $200,000 interest directly attributable to the $600,000 interest income, based on a ratio, the numerator of which is the average accounts receivable that generated the $600,000 United States source interest receipts, and the denominator of which is P's average total assets. A deduction in excess of $600,000 will not be allowed unless it can be shown that the expenses were paid, accrued or incurred at an arm's length rate and were not paid, accrued, or incurred with a principal purpose of tax avoidance.

(c) Same facts as in (a) above except P's annual fee to X is $1 million and P incurs no indirect expense attributable to its $ 1 million annual royalty fee income from A. The trademark agreement between P and A was entered into with arm's length rates and terms and the principal purpose for the payment is not tax avoidance.

P's net royalty income that must be included in the water's-edge combined report is $0 ($1 million royalty fee received from A minus $1 million royalty fee due to X.)

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.

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August 22, 2006

Honorable Steve Westley
Chair, California Franchise Tax Board
300 Capitol Mall, 18th Floor
Sacramento, CA 95814

RE: Petition Requesting Adoption of Regulation Concerning the definition of "US Income" under the Water's Edge Election.

Dear Mr. Westley:

On behalf of our client, the Organization For International Investment ("OFII"), we herby petition the Franchise Tax Board pursuant to Government Code section 11340.6 to amend Regulation 25110(d)(2)(F)(1) to exclude from the definition of "United States income" certain types of "not effectively connected income" as well as income which is effectively connected but not subject to inclusion pursuant to U.S. treaty obligations. A draft of the regulation as proposed to be amended is attached as Attachment 1, which is incorporated herein into this Petition.

We respectfully request that the Franchise Tax Board schedule this matter for a public hearing at its September meeting. Regulation 25110 as currently applied discriminates against foreign commerce by making it more expensive for a U.S. subsidiary to borrow money or license technology from their corporate parent than from unrelated third parties. This makes not only bad economic policy by discouraging foreign investment, but also bad tax policy because it breaks both the spirit and purpose of the Water's Edge election. The proposed amendments are necessary to ensure Regulation 25110 comports with Revenue and Taxation Code section 25110, avoids discriminating against foreign companies, and stops potential double taxation. We have attached a brief summary of the reasons for this request as Attachment 2, which is incorporated herein into this Petition.

Revenue and Taxation Code section 19503 authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section

21001) and Part 11 (commencing with section 23001). The proposed regulatory action interprets, implements, and makes specific Revenue and Taxation Code section 25110.

We look forward to a Board hearing on this Petition. Please feel free to contact me at (916) 446-6752 if you have any questions concerning this Petition.

Sincerely,

Wm. Gregory Turner

enclosure

Cc: Selvi Stanislaus, Executive Officer

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 sections 482or 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 are 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 , subdivision (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 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 362/3 % (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 factors(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 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 etseq.. 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 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) of the Internal Revenue Code 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 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), shall have its United States located apportionment factors and income included in the combined report.

1. United States income.

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 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 . Notwithstanding the above, the term "United States income" does not include income which is not effectively connected with a United States business if either 1. or 2. below applies:

1. an item of interest or intangible income accrued or received, either actually or constructively, directly or indirectly by a corporation, from an unaffiliated corporation; or

2. an item of interest or intangible income accrued or received, either actually or constructively, directly or indirectly by a corporation, from an affiliated corporation where one of the following apply:

(a) the recipient corporation is subject in a foreign country to a tax on or measured by net income with respect to such interest or intangible income; or

(b) the recipient corporation:

(i) paid, accrued, or incurred, the interest or intangible income to a recipient that is not an affiliated corporation, and

(ii) the transaction giving rise to the interest or intangible income of the recipient corporation did not have as a principal purpose the avoidance of federal income tax, and was paid pursuant to a contract or agreement that reflects an arms-length interest rate and terms; or

(c) the interest or intangible income accrued or received, either actually or constructively, directly or indirectly, by the recipient corporation, relates to a contract or agreement entered into with arm's length rates and terms and the principal purpose for the payment is not federal tax avoidance.

3. For purposes of this section intangible income includes income derived from intangible property. Intangible property includes patents, patent applications, trade names, intellectual property, trademarks, service marks, copyrights, trade secrets, shares of stock in corporations and other similar types of intangible assets.

b. Not effectively connected. The United States income of such 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, if such income is considered nonbusiness income under Revenue and Taxation Code section 25120 and the regulations thereunder.

2. For income 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 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 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).

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 Treasury Regulations section 1.863.) 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 Regulations 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 county, 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 atrributable 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)(F) 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.

(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 occuring in taxable years beginning before January 1, 2001.

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

Reference cited: Section 25110, Revenue and Taxation Code .

History:

1. New section filed January 3, 1989; operative January 3, 1989 (Register 89, No. 4).

2. Editorial correction of printing error in subsection (d) (Register 91, No. 32).

3. Amendment of subsections (a), (c)(2)(C)(iii)-(iv), (d)(1)-(3) and (e)(2)(A), new subsections (b)(5), (d)(2)(C)(ii) and renumbering, (d)(2)(C)(iii)(V), (d)(2)(G)(ii)-(d)(2)(G)(ii)(II) and renumbering, repealer of subsection (d)(2)(G)(V) and renumbering filed November 3, 1992; operative December 3, 1992 (Register 92, No. 45).

4. Change without regulatory effect amending subsection (a) and Note filed June 16, 1994, pursuant to Section 100, Title 1, California Code of Regulations (Register 94, No. 24).

5. Amended effective May 3, 2002.

ORGANIZATION FOR
INTERNATIONAL
INVESTMENT

INTERNATIONAL BUSINESS
INVESTING IN AMERICA

Proposed Amendments to Regulation 25110(d)(2)(F)(1)

Summary

The Organization for International Investment ("OFII") is a business association located in Washington, D.C. which represents the U.S. subsidiaries of international companies (membership list attached). U.S. subsidiaries of international companies support 5.4 million American jobs, more than 616,400 in California and growing. In fact, California ranks 1st among all states in terms of "in sourced" jobs in this country.

Regulation 25110 currently makes it more expensive for U.S. subsidiaries to borrow money or license technology from their corporate parent than from unrelated third parties. This makes not only bad economic policy by discouraging foreign investment, but also bad tax policy because it breaks both the spirit and purpose of the Water's Edge election and discriminates against foreign companies. It is inconsistent with Revenue and Taxation Code section 25110.

The Problem

The Water's Edge election was adopted in the mid-1980s following many years of debate and significant international rancor in response the California's forced "worldwide combination" unitary tax methodology. (Cal. Rev & Tax Code Sec. 25110 - 25115) Forced "worldwide combination" offended California's most important international trading partners, in particular the British and Japanese, as it was viewed as an attempt by a sub-state to unfairly tax companies not doing business in California. At one point, the British Parliament even passed retaliatory tax legislation which is still on the books. Under the Water's Edge election, a taxpayer must include in their unitary or combined group those affiliated corporations within the "water's edge" of the United States. This was generally thought to reflect the scope of taxation under federal income tax laws.

Revenue and Taxation Code section 25110, therefore, provides that income included within the water's edge that is derived from or attributable to sources within the U.S. "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*." (Emphasis added.)(Rev & Tax Code § 25110(a)(4).)

In 1989, "activities conducted within the United States" roughly followed federal law. Under CCR Sec. 25110(d)(2)(G)(since renumbered Sec. 25110(d)(2)(F)), "United States income" was defined to include only income that is effectively connected, or treated as effectively connected under the provisions of the Internal Revenue Code, with a United States trade or business ("ECI"). In addition, the regulation recognized the application of U.S. treaties which limit the application of ECI and specifically excluded non-effectively connected income ("NECI").

Effective for taxable years beginning on or after January 1, 1992, however, the FTB amended CCR Reg. Sec 25110(d)(2)(F) to expand the scope of the definition of "United States income" to include not only ECI otherwise protected by treaty but also NECI, United States source income that is not connected to a U.S. trade or business but is business income for California purposes. Staff explained that revised federal reporting requirements imposed on foreign corporations made tracking, and therefore taxing, treaty protected ECI possible, whereas when the 1989 regulations were originally adopted, taxing such income was not administratively feasible. Further, staff concluded without support or analysis that including all U.S. source income that was also business income was "consistent with the thrust" of Rev & Tax Code Section 25110(a)(4).

Although Regulation 25110(d)(2)(F) was amended in 1992 to include treaty protected ECI and NECI within the Water's Edge, the Franchise Tax Board has only recently raised the issue in audits. It has been the experience of OFII members that for more than a decade, the provisions for inclusion of NECI were neither followed nor enforced by the FTB.

Unintended and Undesirable Effects

The effect of Regulation 25110 as currently applied is illustrated in the following example of a common business arrangement: a U.S. subsidiary licenses technology and borrows money from its foreign parent. The U.S. subsidiary pays a royalty under the license arrangement and pays interest on its loan to the foreign parent. Under CCR Reg. Sec 25110(d)(2)(F) as now applied, the U.S. subsidiary, a California taxpayer, must include the income of the foreign parent derived from the royalty and interest payments in their water's-edge combined report. This has several adverse effects:

- It substitutes a "US Source" rule for the express language of Rev & Tax Code Section 25110(a)(4) that limits United States income includible in the water's edge report in a manner that tracks the federal rules on effectively connected income (ECI).
- It may ignore US treaty obligations.
- It effectively circumvents the Water's Edge.
- It ignores the fact that the income of the foreign parent included within the water's edge is likely taxed in a foreign jurisdiction.
- It treats third-party debt financing more favorably than direct foreign investment by a foreign parent or other foreign affiliate.
- It encourages US subsidiaries of foreign parents to borrow money or license technology from unrelated third parties which increases the expenses of the US subsidiary, thereby reducing their overall taxable income.
- It treats lending and licensing transactions differently than other inter-company transactions (sales between related entities are excluded from the sales numerator and denominator).
- For technology owned by the foreign affiliate and for which no reasonable alternative is available, the regulation has the effect of placing third parties at a competitive advantage vis a vis the U.S. subsidiary, because of their ability to deduct royalties paid to the very same foreign entity for use of the same technology.

Not a Tax Avoidance Strategy

OFII believes that regulation 25110's inclusion of NECI is contrary to Rev & Tax Code Section 25110(a)(4) and should be amended accordingly. At a minimum, the regulation should be amended to require the inclusion of NECI only to remedy tax avoidance transactions. Limiting NECI inclusion to tax avoidance situations has been the focus of other states that have confronted this issue. (See, for example, Illinois Stat. 35 ILCS 5/203(b)(2)(E-12) and (E-13).)

Conclusion

The water's edge election is an important part of our tax structure. It protects California's worldwide unitary methodology from possible Congressional action as well as California and U.S. companies operating abroad from retaliatory taxes. Unfortunately, Regulation 25110, by including NECI within the water's edge substantially erodes this important provision and undermines the ability of OFII members to continue and increase investment in this State and the jobs that go with it.

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September 13, 2006

Peter Broom
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San Francisco, CA 94104

Dear Mr. Broom,

It was a pleasure meeting you on September 8th. I am glad that we had the opportunity to discuss issues that are obviously of great importance to your government as well as the state of California. In an effort to provide you with a greater understanding of the areas we discussed, I have had my legal staff draft a short memo setting forth California's treatment of effectively connected and non-effectively connected income. I hope that this memo will aid you in understanding that the position taken by California does not deny any United States subsidiaries of United Kingdom businesses their proper deductions for transactions undertaken with their United Kingdom parents.

As was explained at our meeting, the issue seems to be related to the inclusion of income of the United Kingdom parent without any provision for deductions to be taken against this income. We believe that proper deductions should be allowed and are currently working on addressing this problem. We will be presenting a solution to our three-member Franchise Tax Board at its next meeting.

Please review the attachment and feel free to contact me if you wish to discuss these matters further.

Sincerely,

Selvi Stanislaus

Selvi Stanislaus
Executive Director

Attachment

California Water's Edge Law
Non-Effectively Connected Income and its Effect on Foreign Corporations.

Beginning in 1986, California adopted legislation allowing multinational corporations to avoid worldwide combined reporting by filing their tax returns on a "water's-edge" basis. In general, these provisions allow companies to file their California tax returns only including the income and factors of domestic corporations and other corporations that meet certain requirements set forth in the law[1].

Even if a foreign corporation does not meet any of the requirements to be totally included in the water's edge return, it may still be partially included to the extent that it has U.S. source income[2]. When the waters-edge provisions were first enacted, the FTB, by regulation, limited the extent of U.S. source income to include only income that is "effectively connected" income (ECI) with a U.S. trade or business. For income years beginning on or after January 1, 1992, the regulations were amended to provide that such entities must also include U.S. source non-ECI as determined under the Internal Revenue Code.

Filing Method

If a corporation is fully included in a water's-edge return, all of that entity's net income as well as all the net income of all of the other entities within the return will be added together to determine the total water's-edge income of the filing group. This income is then apportioned to California based on the ratio of property, payroll and sales located in California verses property, payroll and sales everywhere.

The same thing happens for partially included entities, except the net income and factors are limited only to that piece of the foreign corporation's activities which is includable in the water's-edge return.

Intercompany Transactions

If the members of the water's-edge group engage in transactions with each other, these transactions are included in the determination of net income for each member. Of course, income a member receives from another member of the group will similarly be included as an expense on the books of the paying member. The result will be that the transaction is effectively nullified by inclusion of both the income and the expense.

An Example:

Let us assume that one member of a unitary group pays another member a $100 royalty payment. Let us further assume that this transaction is the only income of the member receiving the payment. How would this be reported?

> The member receiving the payment will show a $100 income item from the intercompany transaction and, the member making the royalty payment will show a $100 expense from the transaction. Because both the income and the expense are included in the combined report, the practical effect is that the transaction is a nullity.
>
> In contrast, if the transaction were with a non-related entity, the entity making the payment would still have a $100 expense and while the unrelated entity receiving the payment would $100 of income to report on its own return.

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[1] This is a simplification of the actual rules. As is usually the case with tax provisions, there are intricacies associated with the determination of entities that actually must be included in water’s edge return.
[2] California's water's edge methodology is intended to be including the same entities and income taxed under the Internal Revenue Code, without taking into account treaty over-rides.

What is not taken into account in this example is the fact that the entity receiving the payment probably has expenses related to that income item which it should be able to deduct. For example, if the entity receiving the royalty payment had an expense of $50 related to the income, it should report both the $100 in income and be able to take the $50 of expense to reach a net income of $50 reportable on the water's edge return. This is precisely what the federal and California rules for ECI provide. Therefore, the foreign parent receiving ECI is treated the same as a domestic parent in that its income as well as its expense related to that income is included in determining its net income includable in the water's edge return.

The non-ECI problem

Because the Internal Revenue Code taxes non-ECI at gross income rather than net income, there are no provisions in the Internal Revenue Code that describe how expenses are allowed to determine net income received by a corporation from non-ECI activities. In contrast, California imposes its tax on a net basis. The result is that the intercompany transaction example set forth above becomes distorted in the non-ECI context if an adjustment is not made to allow a deduction for expenses in order to reach a net income figure.

The company paying the royalty fee will always receive the deduction for the payment. This does not change in the non-ECI context. However, there is a change in the income of the member who is including the non-ECI income. While this member will clearly have income reportable on the California return, the amount of this income is no longer reduced for expenses. Therefore, if the expenses related to the non-ECI were $50, without a change in the California regulations, the amount included as income of the foreign parent would be $100, not $50, as was the case where the income was ECI.

The problem is not one of expense for the entity making the payment. The party making the payment can always utilize the expense as a deduction. The problem is the income amount for the party receiving the payment.[3]

California's Response to the Problem

California is now seeking to address the non-ECI problem by providing rules to allow expenses to be taken by the foreign company such that the non-ECI will be included on a net basis. This should reduce or eliminate the overstatement of income and more closely align the treatment of this income to that of other income. This is important not only to eliminate the over-taxation of the non-ECI income, but also to make the income result neutral between payments made to foreign parents and payments made to domestic parents or even third parties. In all of these cases, the income include by the entity who receives the payment should be reduced by expenses. This is not the case if a deduction for directly and indirectly expenses is not allowed.

[3] While it is argued that the California method somehow makes it more costly to borrow money from a foreign parent rather than a third party, this is clearly erroneous. Any interest expense paid by the U.S. subsidiary would be allowed, regardless of whether the lender is the parent or an unrelated third party. The real issue is how much non-ECI the parent will report.

ORGANIZATION FOR INTERNATIONAL INVESTMENT
INTERNATIONAL BUSINESS INVESTING IN AMERICA

TODD M. MALAN, PRESIDENT & CHIEF EXECUTIVE OFFICER

Ms. Colleen Berwick, Board Liaison
Franchise Tax Board
Legal Department
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Dear Ms. Berwick:

On August 22, 2006, the Organization for International Investment (OFII) petitioned the Franchise Tax Board to amend Regulation Section 25110(d)(2)(F)1. The basis for OFII's petition set forth in its Statement in Support of the Petition is that the present regulation makes it more expensive for a U.S. subsidiary to borrow money or license technology from its parent than from a third party, the regulation makes bad economic policy because it discourages foreign investment and bad tax policy because it breaks both the spirit and purpose of the water's-edge legislation, and the regulation discriminates against foreign companies.[1]

The staff of the Franchise Tax Board opposes the amendment proposed by OFII and has sought permission to proceed with its own amendment. This letter is our rebuttal to the staff's response. In summary:

- The staff fails to address the primary issue – that the present regulation is not consistent with the governing statute or the purpose of the water's-edge legislation. Instead the regulation attempts to circumvent the agreed limits of the water's-edge.

- The staff response fails to explain how the regulation does not disadvantage foreign-based companies and incorrectly asserts that OFII's proposal would disadvantage U.S. based companies.

[1] The OFII Statement is attached as Exhibit A to this response.

I. The Current Regulation and FTB Proposal Break the Spirit and Purpose of the Water's-Edge Election.

The purpose of water's-edge election was to create a state tax base that substantially paralleled that of the water's-edge of the United States, i.e., the normal federal income taxation reach, particularly when dealing with foreign entities. Staff does not dispute this.[2]

The statute and the original regulation (and even parts of the continuing regulation) clearly reflect this purpose. The bank or corporation is to be included

> [O]nly 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.... 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.

Section 25110(a)(4).

A. The Current Regulation is Not Consistent With or Authorized by the Statute

Section 25110(a)(4) could easily have used the term "United States source income" to identify the scope of the includable income. It did not. Instead the Section defines the income base as income derived from U.S. sources but limited to income from the entity's activities within the United States. It is the U.S. activities of the recipient entity that are relevant pursuant to the statute, not the activities of the payor. The staff seeks to equate the receipt of NECI with U.S. activities because the payor is a U.S. entity. NECI by its terms means income not connected to U.S. activities of the recipient.

The original regulation, adopted in 1989 shortly after passage of the California water's-edge legislation, reflects this. That regulation expressly excluded from the California water's-edge report income of a foreign corporation not effectively connected with a U.S. trade or business ("NECI") and certain effectively connected income protected by U.S. treaty from federal income taxation.

B. The Federal Scheme Excludes NECI from Income Tax

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[2] The regulation at issue here applies solely to a foreign entity (a foreign bank or foreign corporation with limited presence in the United States) that would have its U.S. taxable income governed by federal standards.

In its response to the OFII petition the Franchise Tax Board staff agrees with OFII that the water's-edge approach was generally thought to reflect the scope of taxation under the federal income tax laws. Both the federal approach to the income taxation of a foreign corporation and the approach of Section 25110(a)(4) set forth in its language are to tax income from activities conducted by that entity within the United States. Not effectively connected income (NECI), by its very title, is not connected to activities conducted in the United States. Rather NECI is (generally) passive income from a United States payor. The federal government has never subjected NECI to income tax. Instead, NECI is subject to a wholly separate regimen, a flat rate withholding tax on the gross amount. That is why there are no deduction provisions for NECI under the federal income tax law. In fact, taxation of NECI is generally eliminated under the more recent United States income tax treaties or reduced to a significantly lower rate (former approach). California, like the other 49 states, has no similar provision.

C. Exclusion of NECI Does Not Upset Any Competitive Balance

The staff argues that a return to the plain language of the statute and the clearer language of the original regulation by exclusion of NECI would somehow violate so-called "Principle Three, competitive balance" from the Working Group's report. The Franchise Tax Board, when it adopted the original regulation 25110 in 1989, apparently did not believe that competitive balance was being harmed by excluding NECI. No United States domestic corporations objected when the original regulation was adopted. Additionally, none of the foregoing nor any member of OFII, other U.S. subsidiaries of foreign corporations or foreign governments expressed concern at the time because ALL parties (FTB and Taxpayers) interpreted the water's-edge solution to the worldwide unitary problem in the same way: exclusion of NECI from the California tax base did not upset competitive balance.[3]

II. The Current Application of the Regulation Makes it More Expensive to Borrow or License from a Corporate Parent Than an Unrelated Party.

The staff misunderstands the point OFII is making. After setting forth in its statement an example of loan and licensing transactions between a domestic subsidiary and a foreign parent not otherwise included in the water's-edge, OFII points out that an unforeseen and probably unintended consequence is to push the subsidiary to borrow from third parties in order to avoid inclusion of the related party's interest income in the unitary return. Since the U.S. subsidiary will generally pay a higher interest rate and incur additional financing costs when borrowing from a third party rather than a related

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[3] In contrast representatives of several foreign interests objected vigorously to inclusion in 1992.

party, the U.S. subsidiary's taxable income will be reduced, paradoxically resulting in less tax revenues for California.

It should be noted that in the case of intercompany licensing transactions, it is generally not possible for the U.S. subsidiary to license intellectual property from an unrelated party due to the proprietary nature of the property. However, the probably unforeseen economic consequence is the effective elimination of the subsidiary's tax deduction through interplay of the inclusion and offset provisions. The bottom line is that the water's-edge income is always overstated.

III. <u>The Current Regulation and the FTB Proposal Discourage Foreign Investment in California.</u>

Again, the staff misunderstands OFII's argument. Because of California's economy, location, diversity, etc. it is, on its face, an extremely attractive location for foreign investment. However, the regulation, in its current form and even with the staff's proposed changes, makes it more expensive for a foreign parent's U.S. subsidiary to operate in California. Thus, the California-based subsidiary becomes less desirable as an investment. Dollars will not be coming into the California-based subsidiary to increase California jobs. Rather investment will stay offshore or be invested in a State with a more favorable taxing scheme for U.S. subsidiaries of foreign parents. The OFII members bring jobs into California. They are not sending jobs out.[4]

IV. <u>The Current Regulation as Applied Discriminates Against Foreign Commerce.</u>

Simply, a foreign parent is not in the same position as a domestic parent where the foreign parent is outside the U.S. without activities in the U.S. Taxing the NECI results in discriminatory treatment of the foreign parent vis-à-vis a similarly situated U.S. parent. Using the example in the staff's response where a U.S. subsidiary pays a royalty to its parent: if the parent company is a U.S. company, both the income and expense are included in the California unitary return and in the U.S. consolidated return and therefore, no net tax is paid on the intercompany payment and receipt of the royalty. However, if the parent company is a foreign company not only is the income and expense included in the unitary return, but the foreign company pays tax on the royalty income in its home country. Thus in the case of a foreign parent, there is additional tax paid. FTB staff argues that it solves the problem by allowing the parent take deductions against the NECI

[4] Staff does not mention other barriers from the staff interpretation: what foreign corporation will want any California investment if it is dragged into a California tax return with its subsidiary every time it receives income not connected to its activities in the U.S. – just because the payor is a U.S. entity (including the U.S. government).

but the real problem is the inclusion of the parent's income in the first place. The staff's proposal to allow expenses would also add the significant costs of expense tracking (to the extent that they can be tracked in a manner satisfactory to the Franchise Tax Board) to the costs of the lending or licensing by a foreign parent.

V. Other Arguments.

Staff and OFII agree that tax abuse should be curtailed and OFII has provided for this (although anti-abuse provisions are already in the California tax statutes). Approximately fifteen other states have passed legislation disallowing the tax deduction for related party expenses where tax avoidance exists. OFII believes this enforcement is appropriate and should be done in a similar manner. This is what is (OFII) suggested in its proposal.

Staff seems to misunderstand OFII's point on the cost of licensing technology where the foreign parent is the sole source. The subsidiary still loses some or all of its deduction because of the income offset whereas a third party's deduction is not offset.

It is interesting what arguments are not addressed by staff: that the express language of Section 25110(a)(4) tracks federal rules on ECI and that the regulation circumvents water's-edge. We have addressed these in the text of this response.

VI. Conclusion.

The OFII proposal is not asking for credits or special provisions. It simply returns treatment of NECI and treaty limitations on ECI to conformity with the plain language and the plain meaning of the statute when applied to foreign corporations. The staff approach has turned every foreign affiliate of a water's-edge group into a California taxpayer if the foreign affiliate has income whose payor is a U.S. entity. This unexpected treatment threatens to re-open an issue which until now was thought to be satisfactorily resolved by the water's-edge legislation and will definitely force foreign businesses to question their wisdom of investing in California.

Sincerely,

Todd M. Malan

September 15, 2006

The Honorable Steve Westly
Member, Franchise Tax Board
300 Capitol Mall, 18th Floor
Sacramento, CA 95814

Subject: APA Petition – Non-Effectively Connected Income

Dear Mr. Westly:

Cal-Tax urges you to accept the petition presented to you by taxpayers and notice their proposal to amend Regulation Section 25110. This will give all parties at a regulatory hearing a chance to fully explain their position and provide a formal venue for discussion.

We think that their was an error made in a 1992 regulatory change, which went unnoticed at the time, to reverse the interpretation of the historic 1986 water's edge unitary apportionment bill (SB 85, Alquist) on the issue of the treatment of non-effectively connected foreign income.

We have talked to key players in the 1986 effort and believe that the overriding aim of the legislation was to prevent the FTB from including, directly or indirectly, income of foreign affiliates, with specific exceptions, in a domestic corporation's combined report.

One of the concerns of state policy makers was the fact that the British government had enacted retaliatory tax legislation in response to California's tax officials including overseas companies not doing business in the USA in a domestic taxpayers combined report. This provision is still the law of the realm, and presumably could still be used in connection with this latest effort to expand the water's edge.

In fact, this problem was created by the staff of the Franchise Tax Board by taking a secret action in 1969 or thereabouts to institute worldwide combination, without a regulatory hearing, notice to taxpayers or any public announcement. As advocates of worldwide combination, staff is still trying to chip away at the water's edge in any way they can.

To require a taxpayer to include within the water's edge, the royalty income of an overseas parent paid by a US taxpayer, we believe is a breach of the water's edge concept established by SB 85. Section 25110 provides certain exceptions to the water's edge that were worked out by all interested parties. We do not read Section 24110 (a)(4) to allow the taxation of non-effectively connected income, because the language states income of a foreign corporation not defined in paragraphs one through three can only be assigned to California to the extent of its sources within the USA and the factors assignable to a location. Since the overseas parent corporation has no factors, we fail to see how this can be included.

Thank you for your consideration.

Sincerely

Teresa Casazza

Teresa Casazza
Vice President and Legislative Director

cc: John Chiang, Michael Genest

CALIFORNIA CHAMBER of COMMERCE

September 19, 2006

By Facsimile and Regular Mail

Honorable Chair Steve Westley
Honorable Member John Chiang
Honorable Member Michael C. Genest
California Franchise Tax Board
300 Capitol Mall, 18th Floor
Sacramento, CA 95814

SUBJECT: REGULATION 25110(d)(2)(F)
SCHEDULED FOR HEARING ON WEDNESDAY SEPTEMBER 20, 2006
Agenda Item 4.a.i – Deductions with Respect to Non-Effectively Connected Income
Agenda Item 4.a.ii – APA Petition – U.S. Income Does Not Include Certain Income

Dear Honorable Chair and Members of the Board:

The California Chamber of Commerce **SUPPORTS** Agenda Item 4.a.ii, which is a petition to modify Regulation 25110(d)(F)1 to clarify that "not effectively connected income" ("NECI") and treaty-protected effectively connected income ("ECI") should be excluded from the definition of "United States income." We respectfully request the Board grant the petition in order to respond to the recent FTB staff practice to include this income. We believe this practice conflicts with the law and the purpose of the water's-edge election. This could seriously harm California's relationship with our foreign trading partners as well as our economy.

It has come to our attention that FTB staff has recently in audits begun to apply Regulation 25110(d)(F)1 to tax multinational affiliate companies doing business in California on NECI. This results in California subsidiaries being taxed on their foreign parent's royalty income, making it more expensive for California subsidiaries to borrow money or license technology from their foreign parents than from unrelated third parties. Although the regulation has been in place since 1992, we understand that FTB staff has only recently begun to enforce it in this detrimental manner.

We believe this new FTB staff practice conflicts with Revenue and Taxation Code Section 25110 and contravenes the intent of the water's-edge election. In 1986, the California Legislature agreed to provide multinational corporations the ability to choose between a worldwide unitary method and a water's-edge election for purposes of California taxation. Those electing water's-edge treatment

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would, with specific exceptions, be taxed only upon income from affiliates within the water's edge of the United States. Accordingly, Revenue and Taxation Code Section 25110 limits income within the water's edge to only that which is derived from activities conducted within the United States. The water's-edge election was the culmination of intense international pressure that witnessed high ranking foreign diplomats lobbying legislative leaders and the Governor's office in favor of a more equitable tax levy to alleviate the burden on foreign corporations doing business in California. Moreover, the water's-edge election averted potential trade retaliation by our foreign partners, which would have had a detrimental effect on our export-dependent businesses.

Thus, we believe taxing California companies on NECI, which is foreign income, is a partial reversal of the water's-edge election agreement. This could reopen the door to the problematic international tax policies the water's-edge election was designed to address. It once again negatively distinguishes California as imposing a higher tax burden on multinational subsidiaries that choose to locate and do business here than do other states. Treating NECI or treaty-protected ECI as United States income could again subject California to intense international pressure and possible trade retaliation measures. It could also harm our economy by undermining our State's efforts to attract new businesses and jobs, drive away existing companies, or deter companies from expanding within the State. Because of this, we believe California will ultimately lose rather than expand tax revenues if it continues to erode the water's-edge election.

On a separate note, we understand that FTB has proposed modifications to Regulation 25110(d)(F)3 in order to facilitate deductions to NECI (Agenda Item 4.a.i.). While we appreciate efforts by FTB to make the deductions process easier for businesses, we are concerned that this proposal overlooks the fundamental problem of including NECI income in the first place. If NECI is excluded, as we believe to be the proper course, the issue of deductions is not applicable to NECI.

For these and other reasons, we **SUPPORT** the pending APA petition to clarify 25110(d)(F)1 and respectfully request the Board grant the petition.

Sincerely,

Kyla Christoffersen
Legislative Advocate, Taxation

cc: Selvi Stanislaus, Executive Officer
John Su, Legal Department

KC:cm

CBI
THE VOICE OF BUSINESS

September 19 2006

The Honorable Arnold Schwarzenegger
Governor of California
State Capitol Building
Sacramento, CA 95814
USA

Dear Governor Schwarzenegger,

Californian Unitary Tax
Franchise Tax Board Hearing on Regulation 25110 – September 20, 2006

I am writing to you regarding the above hearing the subject matter of which is of serious concern to CBI member companies as creating a negative perception of the competitive attractiveness of California as an investment location.

Our concern reflects both the changes in the FTB's position outlined below and the magnitude of British investment in California. The UK is the biggest investor in the US (FDI £149.8bn in 2004), with California taking a large share of this and having the most employees of foreign-controlled companies of any US State.

In 1986, after many years of disagreement between California and foreign governments and foreign business interests and following views expressed by the US Federal Government, California moved from its previous worldwide combined reporting unitary tax to US water's edge election provisions.

This move was wholeheartedly welcomed by the CBI and its member companies as well as by the UK Government and governments and business around the world. The view was that California had taken a clear decision to remedy the damage to the creation of jobs and economic growth in the State created by unitary tax issues.

After 1986 businesses were able to consider California as a destination for investment in the knowledge that the State's decision reflected its new openness to inward investors, to the mutual benefit of all. This was seen as reflecting a welcome new policy imperative for the success of California fully endorsed by the Executive and Legislature.

Unfortunately foreign investors into California have recently been alerted to what appears to be an unfavourable stance on the application of the water's edge rules by officials in the Franchise Tax Board. This stance is perceived as contrary to the spirit and intent of California's 1986 legislation and policy aims.

Richard Lambert – Director-General
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We understand that formal petitions on this issue in relation to Regulation 25110 have been made to California for hearing on the 20th September.

In the light of the history of California's unitary tax and what we believe is a shared desire to encourage trade and investment links between the State and British companies, we would welcome a positive response by the Franchise Tax Board to the views expressed to it in relation to the formal petitions.

We very much hope that you will lend your weight to removing our concerns and that nothing is allowed to create undesirable barriers to British investment in California.

Sincerely,

Richard Lambert

Richard Lambert
Director-General

CBI
THE VOICE OF BUSINESS

September 19, 2006

The Honorable Steve Westly
Chair, Franchise Tax Board
California State Controller
300 Capitol Mall, 18th Fl.
Sacramento, CA 95814
USA

Dear Mr. Chairman,

Californian Unitary Tax
Franchise Tax Board Hearing on Regulation 25110 – September 20, 2006

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Director-General

CBI
THE VOICE OF BUSINESS

September 19, 2006

The Honorable John Chiang
Chairman, California State Board of Equalization
Frnahcise Tax Board
660 S. Figueroa, Ste 2050
Los Angeles, CA 90017
USA

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Franchise Tax Board Hearing on Regulation 25110 – September 20, 2006

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Richard Lambert – Director-General
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Richard Lambert
Director-General

CBI
THE VOICE OF BUSINESS

September 19, 2006

Mr Michael C Genest
Director, Department of Finance
Franchise Tax Board
State Capitol, Room 1145
Sacramento, CA 95814
USA

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Californian Unitary Tax
Franchise Tax Board Hearing on Regulation 25110 – September 20, 2006

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Unfortunately foreign investors into California have recently been alerted to what appears to be an unfavourable stance on the application of the water's edge rules by officials in the Franchise Tax Board. This stance is perceived as contrary to the spirit and intent of California's 1986 legislation and policy aims.

Richard Lambert – Director-General
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We understand that formal petitions on this issue in relation to Regulation 25110 have been made to California for hearing on the 20th September.

In the light of the history of California's unitary tax and what we believe is a shared desire to encourage trade and investment links between the State and British companies, we would welcome a positive response by the Franchise Tax Board to the views expressed to it in relation to the formal petitions.

We very much hope that you will lend your weight to removing our concerns and that nothing is allowed to create undesirable barriers to British investment in California.

Sincerely,
Richard Lambert

Richard Lambert
Director-General