

## Franchise Tax Board

## ANALYSIS OF ORIGINAL BILL

Author: Bates & Nguyen Analyst: Janet Jennings Bill Number: SB 337  
Related Bills: See Legislative History Telephone: 845-3495 Introduced Date: February 13, 2017  
Attorney: Bruce Langston Sponsor: \_\_\_\_\_

**SUBJECT:** DOF in Consultation with FTB Estimate Revenue from Enactment of Federal Corporate Repatriation Statute/Repatriation Infrastructure Fund

### SUMMARY

This bill would among other items, require the Department of Finance (DOF), in consultation with the Franchise Tax Board (FTB), to estimate annually the revenue impact from state taxes relating to enactment of a federal corporation repatriation statute.

This analysis only addresses the provisions of the bill that impact the department's programs and operations.

### RECOMMENDATION - NO POSITION

### REASON FOR THE BILL

The reason for the bill is to secure funding for California's infrastructure.

### EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2018, and operative with respect to the estimate for the 2018-2019 fiscal year completed as soon as practicable after January 1, 2018.

### FEDERAL LAW

A United States (US) corporation is taxed on all its income, regardless of source, and is allowed a credit for any taxes paid to a foreign country on its foreign-sourced income.

A US corporation can operate in foreign countries directly through a "branch" or indirectly through its ownership in a foreign subsidiary. A foreign subsidiary owned more than 50 percent by US shareholders is known as a controlled foreign corporation (CFC). Federal law taxes US-sourced income as well as "subpart F income" of a CFC. Subpart F<sup>1</sup> income generally includes passive income such as dividends, interest, royalties, and rents. Subpart F income may also include shipping income, oil related income, insurance income, and income from certain sales of goods that are neither manufactured nor sold for use in the CFC's home country.

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<sup>1</sup> Subpart F of Part III of Subchapter N of Chapter 1 of Subtitle A of Title 26 of the IRC.

A foreign corporation may derive income from sources within the US. This is referred to as US-sourced income. Examples of US-sourced income are:

1. income earned by a foreign corporation's sales office located in the US,
2. royalties paid from a US corporation to a foreign corporation, and
3. interest paid from a US corporation to a foreign corporation.

A foreign corporation that is a CFC may have both US-sourced income and subpart F income. In addition, some items of income can qualify both as US-sourced and subpart F income (e.g., interest from US Treasury Bonds). To the extent that a CFC has an item of income that is both US-sourced and subpart F income, the income generally will be subject to both the US-sourcing rules and the subpart F income rules. The federal statutes coordinate the US-sourcing and subpart F income rules so that both sets of rules operate simultaneously and apply to a single corporation. The coordination of rules also assures that the same item of income is taxed only once.

Other than the sourcing rules and subpart F rules, a US parent corporation (or US shareholder) is not taxed on the CFC's operating income until the earnings of the CFC are distributed as a dividend under current US rules.

In general, the Internal Revenue Code (IRC) taxes US shareholders of foreign corporations on the entire amount of dividends received from foreign corporations, but only to the extent that the earnings and profits (E&P) of the foreign corporations are derived from foreign-sourced income. As a result, US shareholders have had an incentive to have foreign source earnings and profits in such corporations remain undistributed.

On October 22, 2004, as part of the American Jobs Creation Act of 2004 (P.L. 108-357), Congress enacted IRC section 965 to provide US companies with a temporary incentive to repatriate to the US any earnings held by foreign subsidiaries.

IRC section 965 provides that US companies may elect, for one taxable year, to deduct 85 percent of the dividends they receive from CFCs, but only if they meet certain requirements. Those requirements include that dividends be paid in cash, and that the US shareholders must invest the proceeds from the dividends in the US. The IRC section 965 dividend proceeds do not need to be segregated or traced, and they do not need to be applied to a permitted US investment within a specific time. However, IRC section 965 places limitations on what constitutes a permitted investment within the US, and the dividends must be invested pursuant to a domestic reinvestment plan approved by company management. This plan must be written and state in reasonable detail and specificity the amounts of the anticipated investments in the US.

## **STATE LAW**

In the case of corporations doing business both within and without this state, California, as do most states, taxes corporations exclusively on a source basis, with source income being determined by use of an apportionment formula. Under the worldwide combined reporting method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California and to the unitary members on the basis of relative levels of business activity in the state as measured by the single-weighted sales factor.

As an alternative to the worldwide combined reporting method, California law allows corporations to elect to determine their income on a "water's-edge" basis. Generally, under the water's-edge combined reporting method, an entity incorporated in the US is included in the combined report while a foreign entity is excluded. The law also provides specific rules about whether certain types of entities are included in or excluded from the water's-edge combined report, including the following two special rules:

1. Any affiliated corporation that is a CFC for federal tax purposes is partially included in the water's-edge combined report if it has certain types of subpart F income. In general, the income and apportionment factors of the CFC are included in the combined report based on the ratio of the CFC's subpart F income for federal purposes for the current year to the CFC's E&P for the current year. The ratio can be zero percent but may not exceed 100 percent.
2. Foreign corporations with less than 20 percent of their activities in the US and foreign banks are included in the water's-edge combined report, but only to the extent of their US-sourced income.

Under California law, a CFC that is either a California taxpayer or has income from a US source cannot exclude income from a water's-edge combined report.

## **THIS BILL**

This bill would require the DOF, in consultation with the FTB, to estimate on an annual basis on or before November 1 of each year, the amount of revenue to be received from state taxes in the next fiscal year as a consequence of enactment of a federal corporate repatriation statute pursuant to which foreign earnings of US-based corporations that are invested abroad are moved to the US.

For the 2018-2019 fiscal year, the estimate is to be completed as soon as practicable after January 1, 2018.

This bill would be inoperative as of July 1, 2025, and would be repealed by its own terms on January 1, 2026.

## **IMPLEMENTATION CONSIDERATIONS**

Assuming the federal legislation is passed and the federal Joint Commission on Taxation (JCT) provides revenue estimates for the change in federal tax law, the bill would not significantly impact the department's programs and operations. However, if the JCT estimate is unavailable, implementation would be dependent on the level of assistance the DOF requests from the FTB.

## **LEGISLATIVE HISTORY**

Research of California legislation found no legislation similar to the provisions of this bill.

## **OTHER STATES' INFORMATION**

Since this bill would establish a funding mechanism for California infrastructure under the Government Code, a review of other state tax law would not be relevant.

## **FISCAL IMPACT**

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

## **ECONOMIC IMPACT**

A revenue estimate cannot be provided as the estimate is dependent of future federal action, the details of which are unknown. Should a federal corporate repatriation statute be enacted, the FTB would not have sufficient data to provide an accurate estimate and would rely on a proration of available third-party estimates. Numerous third-party estimates could circulate and we acknowledge the revenue impacts could vary considerably.

## **SUPPORT/OPPOSITION**

Support: None on file.

Opposition: None on file.

## **ARGUMENTS**

Proponents: Some may argue that general fund revenue increases due to specified federal tax law changes should be dedicated to specific infrastructure funding.

Opponents: Some may argue that the current budgetary process already estimates for federal and state tax changes allowing the Governor and Legislature to prioritize spending needs.

## **POLICY CONCERNS**

This bill may be premature due to the lack of any specific proposed federal statutory language and actual passage of federal legislation affecting the repatriation statutes.

The premise of the bill presumes that the general fund revenue would increase due to a provision in the federal administration's proposed budget. The bill fails to consider the unknown revenue impact to the general fund of other pending federal and state tax legislation that could result in losses that exceed the bill's proposed gain.

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