Chapter 2 Water's-Edge Combined Report

Contents:

2.1 Entities Included in a Water's-Edge Combined Report

a. In General

Taxpayers can elect to limit the corporations included in their California combined report to the “water’s-edge group.” There are various requirements to determine whether or not corporations are to be included in the water’s-edge combined report. Generally, domestic corporations are included, and foreign corporations are excluded. There are six different types of entities that must be included. Four of these are included 100 percent, and two are partially included. These corporations comprise the water's-edge group.

The water’s-edge rules do not supersede the unitary concept or California’s apportionment and allocation of income rules. Once a determination is made as to which corporations are unitary and included in the water's-edge combined report, business income, nonbusiness income, and the apportionment factors (throwback rules, double throwback rules, etc.,) are determined using the same rules as those used for worldwide combined reporting. The only effect of the water's-edge election is to limit the corporations included in the water's-edge combined report.

b. Entities to be Included

1. Criteria for Inclusion

There are two criteria that must be met for an entity to be included in the water's-edge combined report:

A. Members of the water's-edge combined reporting group must be unitary with one another. (CCR §25110(d).)
B. An entity must satisfy one of the four tests for 100 percent inclusion, or one of the two tests for partial inclusion. (R&TC §25110(a).)

To determine if a unitary relationship exists, consider Revenue and Taxation Code (R&TC) §25101, and the applicable cases decided by the United States Supreme Court, California courts, California State Board of Equalization and the Office of Tax Appeals. Pursuant to California Code of Regulations (CCR) §25110(d)(1)(B), a unitary relationship is determined **first** by reference to the relationship that exists between **all affiliated** corporations, not just those entities that have income and apportionment factors required to be considered pursuant to R&TC §25110.

Example

Corporation B, a California corporation, is 53 percent owned by Corporation A, an entity incorporated in a foreign country. Corporation C, a New York corporation, is 100 percent owned by Corporation A. Corporation A's activities are conducted entirely outside the US. Due to significant intercompany product flow with Corporation A, Corporation B and Corporation C are each unitary with Corporation A. Although Corporations B and C have no direct unitary ties with each other, they are considered unitary on a worldwide basis. (*Appeal of Monsanto Co.,* 70-SBE-038, November 6, 1970.) Corporation B elects to determine its income on a water's-edge basis and would include Corporation C in its combined report. The income and factors of Corporation A generally would be excluded due to the water's-edge election.

If an entity is unitary and satisfies any of the tests listed below, it must be included in the water's-edge combined report. Note, even if the unitary requirement is met, an entity that does not meet any of the tests listed below must be excluded. (CCR §25110(d)(1).)

Accordingly, a determination is first made as to the members of the worldwide unitary group. Next, a determination is made as to the members that meet the criteria for inclusion under R&TC §25110(a). These are the members that would make up the composition of the water's-edge group.

2. Water's-Edge Group

R&TC §25110(a) provides that the following types of "affiliated" entities are included in the water's-edge combined report:

A. Entities 100 Percent Included

i. Foreign Sales Corporations (FSC) (Former Internal Revenue Code (IRC) §§921-927) and Domestic International Sales Corporations (DISC) (IRC §§991-994).

ii. Corporations, regardless of where they are incorporated, with 20 percent or more average apportionment factors within the US. This rule does not apply to banks.

iii. Corporations incorporated in the US, which are owned and controlled more than 50 percent by the same interests.

iv. Export Trade Corporations (ETC), described in IRC §§970-972.

B. Entities Partially Included

i. Controlled Foreign Corporations (CFC) if they have Subpart F income, as defined in IRC §952. CFCs are included based on the ratio that their Subpart F income bears to their total earnings and profits (E&P) for the current year.

ii. Any corporation not described above, that has income attributable to sources within the US, is included in the water's-edge combined report, but only to the extent of its US located income and factors.

If a corporation meets the inclusion criteria under both (B)(i) and (B)(ii) above, it must include both items of income in the water's-edge combined report. A CFC cannot exclude its income determined under Subpart F income from its water's-edge combined report, even if it is a California taxpayer or has income from a US source. (R&TC §25110(a)(2).)

C. Affiliated Entity Defined

An “affiliated” bank or corporation means a bank or a corporation that is a member of a commonly controlled group, as defined in R&TC §25105. (R&TC §25110(b)(1).) The ownership rules of R&TC §25105 contain an over-50 percent “single-entity” standard, except for situations involving family ownership and stapled stock. The ownership requirements of R&TC §25105 apply in the same manner, for both worldwide and water's-edge taxpayers. (See Multistate Audit Technique Manual (MATM) 3040 for more information.)

c. Foreign Sales Corporations and Domestic International Sales Corporations

1. In General

In 1971 Congress enacted the DISC provisions and, in 1984, the FSC provisions. The FSC provisions were intended to mirror the DISC provisions. The primary distinction between the two provisions is that DISCs are US corporations and FSCs are foreign corporations. These provisions provide relief from federal taxation of earnings from export corporations. Although the FSC provisions were generally designed to replace the DISC provisions, the DISC provisions are still available in a modified form.

These were the types of corporate structures available under these provisions:

- FSC
- Small FSC
- DISC
- Interest Charge DISC

Any unitary corporation that meets the federal requirements to qualify as a FSC in accordance with former IRC §922, or a DISC in accordance with IRC §992, must be included in the water’s-edge combined report.

2. Repeal of the FSC Rules

In general, Public Law (PL) 106-519, the Extraterritorial Income Exclusion Act of 2000, effective for transactions after September 30, 2000, repealed the FSC rules.

d. Export Trade Corporations

Any unitary corporation meeting the requirements of an ETC, as defined by IRC §971, must be wholly included in the water's-edge combined report. (R&TC §25110(a)(1)(D).) If a CFC qualifies as an ETC, the qualifying income is not considered taxable Subpart F income for federal purposes. However, to be treated as an ETC, a CFC must have qualified before taxable years beginning before October 31, 1971. The ETC rules were repealed in 1986. Because of the repeal date, Export Trade Corporations are almost nonexistent. For further discussion of the export trade rules, see IRC §§970 and 971.

e. Entities with United States Source Income

Foreign organized banks or any corporation, not meeting another test for inclusion in a water's-edge combined report, must include any income and factors attributable to US sources, as determined by federal income tax laws, and their factors assignable to the US, under state apportionment rules in the water's-edge combined report. (R&TC §25110(a)(2)(A)(i).)

Foreign corporations with less than 20 percent US factors and foreign banks must include their US factors and income in the water's-edge combined report. Generally, the federal income sourcing rules, as described in IRC §§861-865, are used to determine includible amounts of income and expense for California purposes. However, consideration must still be given to the California taxable income. The US located apportionment factors are determined in a manner consistent with the US located income and in accordance with the R&TC.

A more detailed explanation of the federal US source income and expense rules is discussed in WEM 5.

f. S Corporations

1. In General

An S Corporation can make a water's-edge election. Although an S Corporation cannot have corporate shareholders, an S Corporation may own corporations. R&TC §23801(c) generally precludes the inclusion of an S Corporation in a combined report, even if it has a unitary relationship with other corporations. Because an S Corporation is required to file on a separate company basis, a water's-edge

election will not have any effect on the S Corporation's separate company filing status. Although C Corporations filing on a water's-edge basis are required to file on a California Form 100W, an S Corporation filing on a water's-edge basis continues to file a California Form 100S.

2. S Corporations and Transfer Pricing

Because the S Corporation files on a separate company basis, the potential for a transfer pricing issue can exist. If there is a transfer pricing issue between an S Corporation and an affiliate, an attempt must be made to find a comparable uncontrolled price (CUP) as described by the principles of IRC §482. If a CUP does not exist and the arm's-length income cannot be determined by reference to a CUP, then the FTB has the ability to use combined reporting as a means of properly reflecting the income or loss of the S Corporation and the members of the commonly controlled group. (R&TC §23801(d)(1).) If this occurs with a water's-edge S Corporation, then the entities subject to inclusion in the combined report are limited to the entities described in R&TC §25110(a). (If the S Corporation has not made a water's-edge election, then Franchise Tax Board can require a worldwide combined report as a means of correcting the transfer pricing issue.)

3. S Corporations with Affiliated CFCs

An S Corporation can own or be a brother/sister with a CFC. As discussed above, however, the CFC cannot be combined with the S Corporation. The S Corporation must file its own California Form 100S on a separate company basis. The CFC would only file a Form 100W if it is a California taxpayer.

g. Partnerships, Joint Ventures and Other Hybrid Entities

If a water's-edge taxpayer owns an interest in a partnership, and the partnership's activities are unitary with the corporation's activities, disregarding the 50 percent ownership requirement, that corporation's share of the partnership's trade or business income or loss and factors are combined with the corporation's trade or business. The corporation's distributive share of the partnership's income or loss and factors must be included in the water's-edge combined report. The location of the partnership activities is not relevant. The inclusion of partnership items in the water's-edge combined report has the same

application as that already present in worldwide combined reporting. In other words, the same rules apply.

The treatment of partnerships, joint ventures, and other hybrid entities can vary for California, federal and other state tax purposes. The distributive share of income and factors of a foreign partnership owned by a US entity, if unitary, is generally included in the combined report. If not unitary, the distributive share of income and factors is generally excluded.

The correct classification of material foreign entities can be significant. The provisions of R&TC §23038, and the regulations promulgated thereunder, apply. By reviewing the foreign entity's organization documentation and the foreign law, verification of the proper classification, e.g., partnership, corporation, etc., can be achieved. This is especially relevant for any material entity organized under a "unique" foreign statute (i.e., foreign statute not comparable to US law), or an entity that is not identified as a "per se" corporation in CCR § 23028-2(b).

2.2 Corporations with Twenty Percent or more United States Activity

a. In General
b. Application of Treaty Provisions
c. Free or Foreign Trade Zones
d. Rules to Determine the Activity Test
e. Computing the Activity Test
f. Possession Corporations

a. In General

Any corporation, whether organized in the US or in a foreign country, must be included 100 percent in the water's-edge combined report if the average of its property, payroll, and sales factors within the US is 20 percent or more. (R&TC §25110(a)(1)(B).)

This determination must be made annually and computed separately for each affiliate. The double-weighted sales factor is not considered when determining if a corporation has a 20 percent or greater average US factor.

As discussed in WEM 2.1(f), R&TC §23801(c) precludes S Corporations from being included in a combined report. An S Corporation is only included in a combined report when a transfer pricing issue cannot be resolved by the use of a CUP pursuant to the IRC §482 arm's length standard.

In applying the 20 percent test for inclusion, the actual factor percentage calculated for each individual state should be used, if it exists, using the apportionment factor rules of that state. (CCR §25110(d)(2)(B)3.) If a corporation on a worldwide basis does not have one or more of the property, payroll, or sales factors, that factor will be disregarded in computing the average of its factors within the US. (CCR §25110(d)(2)(B)2.) If a state does not have a statute providing for an income tax or does not use a particular apportionment factor in its apportionment formula, CCR §25110(d)(2)(B)3.b. provides that the utilization of California's rules for computing that factor should be substituted.

For activities arising in interstate commerce to be taxable by a state, there must be nexus to tax, and there must be no exemption from taxation such as that set forth in PL 86-272. Commerce between the

US and Puerto Rico is considered to be interstate commerce. (See FTB Legal Ruling (LR) 99-1, January 6, 1999.)

For activities arising in foreign commerce to be taxable by a state, there must be nexus to tax. (R&TC §23101.) PL 86-272 has no application to foreign commerce. (Foreign commerce means commerce between the US and a foreign country.) It is not relevant that the taxpayer does not file a return in the destination state, or that the state chooses not to tax the activities in question. (CCR §25110(d)(2)(B)3.) What is relevant is whether the state could tax the activities if it chose to do so. Thus, sales of tangible personal property into the US by a foreign corporation will be includible in the sales factor if the foreign corporation has nexus in the state to which the goods were shipped. Nexus is determined on a state-by-state basis. (For further discussion of nexus and PL 86-272, see MATM 1100-1240.)

If the annual report presents property and sales information geographically, detail might be requested on an entity-by-entity basis. This can be used in determining if the taxpayer has sufficient activity within the US to *potentially* meet the 20 percent US activity test. However, before any sales can be assigned to a state, the entity must be taxable in the state under the laws and constitution of the US. Therefore, once it has been identified that there is sufficient activity within the US to give rise to a 20 percent or greater US factor, it must still be determined if the entity has sufficient presence in the US to be able to assign the factors to the US. This will require a detailed examination of the entity's activities in the US, including the activities of an agent on its behalf, to determine if the entity has taxable nexus. (In the case of commerce between the US and Puerto Rico, for the determination of taxability, PL 86-272 applies. That is, whether the entity's activities exceed solicitation of sales protected under PL 86-272. See FTB LR 99-1, January 6, 1999.)

Any corporation with 20 percent or more of its average property, payroll and sales in the US must include all of its income and factors in the combined report.

b. Application of Treaty Provisions

If the taxpayer files a federal Form 1120F, a review can be made to see if the foreign corporation is claiming a treaty-based exemption. In a section of the federal Form 1120F, the following question is presented: "Is the corporation taking a position on this return that a

US tax treaty overrules or modifies an Internal Revenue law of the United States thereby causing a reduction of tax?" If an affirmative response is provided, a completed federal Form 8833 must be included with the federal Form 1120F. If applicable, a separate Form 8833 is required for each treaty-based return position taken. Both this question on the federal Form 1120F and the Form 8833 can be reviewed to determine if any treaty provisions apply.

For purposes of the 20 percent US activity test, it is irrelevant whether the corporation is claiming tax treaty immunity for federal tax purposes. Tax treaty provisions, including the permanent establishment rules, generally apply to the US and the applicable foreign country. These rules are not applicable for purposes of determining if a foreign entity has a taxable presence in a particular state. For purposes of determining taxable nexus, the laws and constitution of the US bind the states. However, if the taxpayer is claiming a treaty exemption, it may provide an indication that the foreign corporation may have a presence in the US and, therefore, have US-based property, payroll, or sales.

c. Free or Foreign Trade Zones

It is also necessary to determine if a corporation is operating in any Free Trade Zones, also known as Foreign Trade Zones. Corporations can warehouse, assemble, and manufacture goods within a Free Trade Zone. Such goods are exempt from US Customs duties and federal excise taxes until the goods are shipped from the zone. The income derived from the sale of goods located in a US Free Trade Zone is not exempt from federal income tax. However, it may be exempt by treaty. (See Rev. Rul. 76-161.) As discussed above, the federal treaty immunity rules are not relevant for purposes of the 20 percent activity test.

As a general rule, storing property within a state is sufficient to establish taxable nexus. The value of such property would then be included in the numerator of the property factor for that state. However, if inventory is simply warehoused in a state for a brief period of time awaiting further transportation to the ultimate destination, (i.e., the goods pass through the state as part of a "stream of commerce,") generally neither the inventory nor the sale would be assignable to that state. Alternatively, if the purchaser takes possession (or constructive possession through an agent or bailee) so that the goods leave the stream of commerce within a state, such as for inspection or minor assembly work, the inventory and the sale are

assignable to that state. For further discussion of this issue, see *Appeal of Mazda Motors, Inc.*, 94-SBE-009, November 29, 1994; LR 95-3, July 20, 1995; and *McDonnell Douglas v. Franchise Tax Board* (1994) 26 Cal. App. 4th 1789.

d. Rules to Determine the Activity Test

The computation of the 20 percent activity test for inclusion of an entity in the water's-edge combined reporting group is based upon a simple average of its property, payroll and sales factors within the US (R&TC §25110(a)(1)(B)). The amendments to R&TC §25128 that result in the reporting of a single weighted sales factor to apportion business income does not apply when determining if an entity is includible in a water's-edge combined report under the 20 percent activity test. (R&TC §25110(a)(1)(B) and Legal Ruling 95-5.)

To determine the percentage for each factor, the following rules apply:

1. Determine the percentage for each factor in each state in which a corporation is taxable. If the state assesses a tax on or according to income, then the rules of that state apply. (CCR §25110(d)(2)(B)3.a.) For example, the rules of that state may include property in the factor at net book value instead of original cost. However, double weighting of a sales factor by any state is not taken into consideration in determining if the entity has a 20 percent or more average US apportionment factor. Double weighting does not change the sales factor amount, it simply gives greater weight to that factor for purposes of determining the amount of income apportioned to that particular state. (LR 95-5, October 13, 1995; R&TC §25128.)

2. With respect to any state that does not impose a tax on, or according to income, or does not assign income using an apportionment formula consisting of property, payroll, and sales, the corporation must compute the property, payroll, and sales of that state utilizing the California apportionment rules for the factor not used by that state. (CCR §25110(d)(2)(B)3.b.)

3. If the property, payroll, or sales in a state are not defined in a substantially uniform manner, then the taxpayer may elect, but is not required, to compute each factor in accordance with the California apportionment rules. (CCR §25110(d)(2)(B)3.c.) "Uniform manner," means consistent with the Uniform Division of Income For Tax Purposes Act.

4. In addition, no item of property, payroll, or sales shall be assigned to more than one state. The taxpayer shall determine to which of several states an item shall be assigned. (CCR §§25110(d)(2)(B)3.e.)

5. To compute the sales factor:

   a. Any sales made by the corporation to a member of the water's-edge combined report group are eliminated from the numerator and denominator of the factor. (CCR §§25110(d)(2)(B)3.d.)

   b. Throwback sales are to be included in calculating the sales factor to the extent required under the applicable state law. (CCR §25110(d)(2)(B)3.) However, if these sales are made to an affiliate in the water's-edge combined report group they would be eliminated from the computation.

   c. In computing the sales factor component for the 20 percent activities test under CA apportionment rules, the numerator and denominator of the factor should be based upon the rules provided in the R&TC, commencing with R&TC §25120. (R&TC §25110(b)(3) and CCR §25110(d)(2)(B).)

      Sales of tangible personal property shall be assigned based upon the rules under R&TC §25135 and related regulations for the taxable year at issue.

      Sales from other than tangible personal property shall be based upon the rules under R&TC §25136 and related regulations for the taxable year at issue. For example, a taxpayer that is required apportion income using the single factor sales for tax year 2014, shall determine the assignment of sales for purposes of the 20 percent activity test using the market-based sourcing rules as provided by R&TC §25136 and CCR §25136-2.

d. Qualified cable companies meeting the requirements of R&TC §25136.1 and agricultural, extractive, savings and loan and banking or financial companies meeting the definitions of a qualified business activity under R&TC §25128(b) will use the special apportionment rules provided under the respective R&TCs and related regulations.

6. The 20 percent or greater US activity test is an annual test. Thus, a corporation may be eligible for inclusion in one tax year, but not in another. Also, the test is computed separately for each separate corporate entity, based on its activities in the US. (The *Finnigan or Joyce* decisions have no application in determining whether a particular entity has a 20 percent or greater US apportionment factor.)

e. Computing the Activity Test

Due to the different rules in each state, the factor percentages must be determined on a state-by-state basis. Thereafter, the percentages are combined and averaged to determine if it is 20 percent or greater. For each state, each US property, US payroll, and US sales factor is determined. All US factors are combined, and divided by three. If the result is 20 percent or more, the corporation is 100 percent included in the water's-edge combined report.

Example

ABC Ltd. (a foreign corporation) has worldwide property of $1 million, worldwide payroll of $500,000, and worldwide sales (excluding intercompany sales) of $420,000. ABC Ltd. has constitutional nexus in each state to which it ships goods. It has no property or payroll in the US. Its third-party sales are as follows:

Third-Party Sales To:	
Pennsylvania	$125,000
New Mexico	30,000
California	100,000
Foreign	165,000
Total Third-Party Sales	$420,000

The factors in each state, calculated using the rules of the respective states, are as follows:

	US	Worldwide	%
Pennsylvania:			
Property	$0	$1,000,000	0%
Payroll	$0	$500,000	0%
Sales	$125,000	$420,000	29.7619%
New Mexico:			
Property	$0	$1,000,000	0%
Payroll	$0	$500,000	0%
Sales	$30,000	$420,000	7.1429%
California:			
Property	$0	$1,000,000	0%
Payroll	$0	$500,000	0%
Sales	$100,000	$420,000	23.8095%
Total US Apportionment Factor			60.7143%
(Divided by 3) Average US Apportionment Factor			20.2381%

Because ABC Ltd.'s average of its property, payroll, and sales factors in the US is more than 20 percent, 100 percent of its factors and net income will be included in the water's-edge combined report. Note that none of the factors were double-weighted even though state statutes may require it. This is because the double-weighting is done after the factor is determined and is not part of the factor computation itself.

f. Possession Corporations

1. In General

Although Puerto Rico is not one of the 50 states, as a US possession, it has a unique status that allows commerce between the US and Puerto Rico to be protected under PL 86-272. (See LR 99-1, January 7, 1999.) Therefore, a corporation's business activities within a state must exceed solicitation of sales before its sales from Puerto Rico into the US may be considered US sales for purposes of the 20 percent test.

Example

Acme PR is a possession corporation, which assembles broomsticks. Acme PR assembles 1,200 broomsticks. It sells its finished product to distributors in the US. 1,000 of the broomsticks are sold to Acme US, its parent corporation. 200 broomsticks are sold to Hazel's Rent-a-Broom located in California. All sales are at the same price. Acme PR's activities in California exceed solicitation of sales. The following determines Acme PR's US sales factor.

Total Sales	1,200 units
Less Intercompany Sales	(1,000 units)
Net Sales	200 units
US Sales/Net Sales is the Activity Test %	200/200 = 100%

If there were no payroll or property factors in the US, Acme PR's average US factor would be 33 percent [(0% + 0% + 100%) / 3 = 33%], and would meet the 20 percent test. Therefore, Acme PR would be wholly included in the water's-edge combined report.

2. Repeal of IRC §936

IRC §936 provided a corporation, which elected to be treated as a possession corporation, a possession tax credit for federal purposes. A possession corporation was required to file a separate federal Form 1120, and generally received a credit for taxable income derived from the active conduct of a trade or business in a US possession. IRC §936 was repealed for any taxable year beginning after December 31, 1995. After this date, a corporation could no longer make the election to be treated as a possession corporation. However, existing possession corporations were provided rules to gradually reduce the benefit of the tax credit. This phase out ended in 2005. The possession tax credit is no longer provided for tax years after December 31, 2005.

2.3 Controlled Foreign Corporations

a. In General
b. Subpart F income
c. Water's-Edge Application – Includible Activities of a CFC
d. California CFC Considerations

a. In General

For California water's-edge combined reporting purposes, any CFC, as defined in IRC §957, with Subpart F income as defined in IRC §952 is included in the water's-edge combined report. (R&TC §25110(a)(2)(A)(ii).) The inclusion of a CFC's income and factors depends upon the ratio of the CFC's current year Subpart F income to its current year E&P. Accordingly, the ratio of inclusion varies annually. This is different from the full inclusion of the CFC's income and factors in a worldwide combined report. In addition, there are significant differences between state and federal law in the treatment of CFCs with Subpart F income.

Generally, a CFC is an entity that is organized in a foreign country, and which is owned greater than 50 percent by US shareholders on any day during the taxable year of the foreign corporation (IRC 957(a) and Treas. Reg. §1.951-1(a)). Treas. Reg. §1.951-1(g)(1) defines the term "US shareholder." US shareholders do not have to be related to each other. Direct and indirect ownership is considered. (IRC §958(a)) In addition, the constructive ownership rules apply. (The constructive ownership rules or attribution rules under IRC §318(a) apply as referred by IRC §958(b).) The over 50 percent ownership test applies to the total combined voting power of all classes of stock entitled to vote or the total value of the corporate stock.

A CFC generally cannot be partially included in a combined report with an S Corporation because of the provisions of R&TC §23801.

b. Subpart F Income

The term "Subpart F income" refers to the location of the provisions in the IRC, Subtitle A, Chapter 1, Subchapter N, Part III, "Subpart F." For federal purposes, if a foreign corporation meets the definition of a CFC, then any of its income that meets the definition of Subpart F income is considered a deemed dividend to the US shareholder, regardless of whether the income is actually distributed. California never conformed to these code sections. However, R&TC §25110 uses

some of the definitions and concepts found in Subpart F, specifically IRC §952, for purposes of computing the numerator of the CFC's inclusion ratio only.

For federal purposes, IRC §951 requires US shareholders to include in its gross income the:

- Pro rata share of Subpart F income determined under IRC §952
- Pro rata share of previously excluded Subpart F income withdrawn from investments in less developed countries (IRC §955)
- Pro rata share of excluded Subpart F income withdrawn from foreign base shipping operations(IRC §955)
- Investment of earnings in US property (IRC §956)

On December 22, 2017, President Trump signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act of 2017 (Act). The Act made sweeping changes to the federal income tax law, including changes to the international tax provisions under the IRC. The Act added IRC §951A imposing a current tax on a US shareholder's "global intangible low-taxed income" (GILTI) of a CFC.

New IRC §951A subjects US shareholders of CFCs with GILTI to current tax. The full amount of the US shareholder's share of the GILTI is treated as an income inclusion, but US corporations are provided a 50 percent deduction (reduced to 37.5 percent in 2026). The earnings subject to the tax exclude a 10 percent return on certain investments, reduced by net interest expense. The tax on GILTI is intended to reduce the incentive to relocate CFCs to low-tax jurisdictions, since any tax savings achieved by the CFC may be partially offset by an increase in taxes to the US shareholders.

The existing California R&TC does not incorporate by reference IRC §951A. In addition, the water's-edge provisions within the California R&TC do not specifically refer to IRC §951A. Therefore, existing California water's-edge provisions do not conform to the new federal GILTI repatriation provisions.

Subpart F income is defined by IRC §952, which includes:

- International Boycott Income (IRC §§952(a)(3) and 999)
- Income From Illegal Bribes and Kickbacks (IRC §952)
- Insurance Income (IRC §953)
- IRC 901(j) Foreign Country Income (IRC §952(a)(5))
- Foreign Base Company Income (FBCI) (IRC §954)

In computing Subpart F income, IRC §952(c) provides rules related to recapture, recharacterization, prior year deficits and qualified chain rule. As discussed in WEM 2.3, section c., California does not conform to the rules provided in IRC §952(c) when computing the CFC's inclusion ratio.

- ✓ Recapture and Recharacterization Rule – For federal purposes, Subpart F income is limited to current E&P. The excess is put into a recapture account, then recharacterized as Subpart F income in a future year when current E&P exceeds Subpart F income. (IRC §952(c)(2).)

- ✓ Prior Year Deficit – Any deficits in E&P from prior years can be carried over to reduce current E&P, which may limit the Subpart F income recognized in current year. This is similar to the NOL rules that allow losses from prior years to reduce current year net income. Only qualified deficits can be carried over to reduce current year E&P.

- ✓ Qualified Chain Rule - Losses can also be carried over from related parties under the qualified chain deficit rule. If the related party is 100% owned and organized in the same country, the deficits from this related party can be carried over to the CFC in order to reduce their current E&P.

See IRC §952(c) for a further detail.

For California purposes, any income included in the shareholder's income pursuant to IRC §951, including Subpart F income, shall be excluded from gross income. Although California excludes the above deemed dividends from gross income, once actual distributions of the E&P occurs, the dividends will be included in income for California purposes and subject to dividend deductions (i.e., R&TC §24411) and eliminations (R&TC §25106).

For federal purposes, the components of Subpart F income have changed over the years. The most common type of Subpart F income is FBCI. There are many federal rules that apply within each of these income categories. In addition, the rules have varied from year to year. To obtain a more detailed understanding of these rules, please refer to the IRC and Treasury Regulations.

1. Foreign Base Company Income

IRC §954(a) defines the various types of FBCI, which include the following four categories:

- Foreign Personal Holding Company Income (IRC §954(c))
- Foreign Base Company Sales Income (IRC §954(d))
- Foreign Base Company Services Income (IRC §954(e))
- Foreign Base Company Oil Related Income (IRC §954(g))

Within each category of FBCI, a number of specific exceptions apply when calculating the amount of Subpart F income. These include, but are not limited to the following exceptions:

- Same country
- Active conduct of a trade or business
- Manufacturing

Refer to the IRC and the Treas. Reg. for a complete discussion of the applicable exceptions that apply within each category of FBCI.

Foreign personal holding company income (FPHCI) consists of passive income. There are 8 categories of FPHCI, with dividends, interest, royalties, rents and annuities being the most common.

1. Dividends, interest, royalties, rents, and annuities
2. Excess of gains over losses from certain property transactions
3. Excess of gains over losses from transactions in any commodities
4. Excess of foreign currency gains over foreign currency losses
5. Income equivalent to interest
6. Income from notional principal contracts
7. Payments in lieu of dividends
8. Personal service contracts

In addition to the exceptions within each of the FBCI categories, IRC §954(b) describes certain rules that apply to FBCI and insurance income. These special rules do not apply to the other categories of Subpart F income, i.e., international boycott income, income from illegal bribes and kickbacks, and income from IRC §901(j) foreign countries. The special rules include:

- Full inclusion Rule
- De minimis Rule
- High foreign tax Rule
- Anti-abuse Rule

California incorporates the rules provided by IRC §954(b) as referenced in CCR §25110(d)(2)(E)3. Even though California does not assess a franchise tax against insurance companies, for purposes of these additional rules, insurance income is considered. However, if the result of any of these rules is to include income for federal purposes from a bona fide insurance company, California would not assess a tax against the insurance company nor include the insurance company in the California combined report.

A. Full Inclusion Rule

The full inclusion rule is described in IRC §954(b)(3)(B) and provides that if the sum of the FBCI and the gross insurance income exceeds 70 percent of the CFC's total gross income, then 100 percent of the CFC's income constitutes either FBCI or insurance income. Again, gross insurance income is defined as any item of gross income taken into account pursuant to IRC §953.

If the full inclusion rule is met, then 100 percent of the CFC's gross income must be included as Subpart F income. Treas. Reg. §1.954-1(b)(1)(ii) clarifies that the insurance income would remain classified as insurance income. All other remaining gross income would be classified as FBCI.

B. De Minimis Rule

The de minimis rule, described by IRC §954(b)(3)(A), allows a foreign corporation to have a minimal amount of FBCI and insurance income without becoming subject to the Subpart F provisions. If the sum of the FBCI and the insurance income is below the following minimum amount, then the FBCI and the insurance income are not considered to be Subpart F income.

The de minimis rule provides that none of the CFC's gross income is treated as Subpart F income if the sum of the FBCI and the gross insurance income of a CFC is less than the lesser of either:

- 5 percent of a CFC's total gross income
- $1,000,000

Gross insurance income is defined as any item of gross income taken into account, pursuant to IRC §953. For purposes of applying this de minimis rule, if the CFC's currency is not the US dollar, then the $1,000,000 threshold must be translated into the functional currency of the CFC using the weighted average exchange rate.

C. High Foreign Tax Rule

1) In General

The high foreign tax rule, described in IRC §954(b)(4), provides that FBCI and insurance income can be excluded from Subpart F income if the income is subjected to an effective foreign income tax rate that is greater than 90 percent of the maximum US tax rate, and the taxpayer establishes this to the satisfaction of the Secretary. In general, if the high foreign tax rule is met, the CFC is not considered to be organized primarily to avoid US income tax. If the high foreign tax rule is met, the taxpayer has the option of including this income as Subpart F income or making an election to exclude the income. Thus, if the high foreign tax rule is met and the taxpayer makes an election to exclude the income, the CFC's income will not be considered Subpart F income.

This rule applies separately to each "item of income" received by the CFC. Per Treas. Reg. §1.954-1(c)(1)(3), the following are considered separate "items of income":

- Foreign Base Company Income: Non-passive Foreign Personal Holding Company Income
- Foreign Base Company Income: Passive Foreign Personal Holding Company Income
- Foreign Base Company Income: Sales Income, Service Income, Full Inclusion Income

Passive Foreign Personal Holding Company Income must be further segregated into the separate categories of income, which are referred to as “baskets,” listed under IRC §904(d).

2) California High Foreign Tax Election

A water’s-edge taxpayer may make a separate state-only election for purposes of computing its inclusion ratio even if the taxpayer did not make a high tax election to exclude Subpart F income for federal purposes. As mentioned above, for purposes of the water’s-edge combined report, the income and apportionment factors of any CFC are included based on the ratio of the CFC’s current year Subpart F income for federal purposes to the CFC’s current year E&P. (R&TC §25110(a)(2)(A)(ii).)

California adopted, with some modifications, the federal definition of Subpart F income for purposes of determining the portion of the income and factors of a CFC to be included in a water's-edge combined report. IRC §954(b)(4) provides that FBCI, as defined in IRC §954(a), does not include any item of income if the taxpayer can establish that the income was subject to income tax at an effective tax rate imposed by a foreign country greater than 90 percent of the maximum federal rate. A taxpayer may elect to exclude this income from Subpart F income, although taxpayers wishing to avail themselves of foreign tax credits may choose not to make the federal election.

As the following indicates, a separate election may be made for California purposes only. The statute and regulation refer to Subpart F income as defined in IRC §952, and specifically provide for certain modifications to the federal amount. CCR §25110(d)(2)(E)3 specifies that IRC §954(b) applies in determining Subpart F income for California purposes. Therefore, IRC §954(b), and the high foreign tax election it provides for, is adopted by reference to California law.

R&TC §23051.5(e) provides in pertinent portion:

> Whenever this part allows a taxpayer to make an election, the following rules shall apply:
>
> (1) A proper election filed with the Internal Revenue Service (IRS) in accordance with the IRC or Treas. Reg. issued by "the secretary" is deemed to be a proper election for purposes of this part, unless otherwise expressly provided in this part or in regulations issued by the FTB.
>
> ….
>
> (3)(A) Except as provided in subparagraph (B) [operative for years beginning on or after January 1, 2004, relating to federal elections made prior to the time the taxpayer becomes subject to California tax], in order to obtain treatment other than that elected for federal purposes, a separate election must be filed with the FTB at the time and in the manner that may be required by the FTB.

While a separate election is available, a taxpayer making a California only election must provide, upon FTB request, schedules showing the computations and source documentation that would have been required to support such election for federal purposes.

3) High Foreign Tax Rate

The election is available for income from jurisdictions, which impose a tax, which is greater than 90 percent of the highest federal rate. In this computation, 90 percent of the maximum federal rate must be applied. The maximum California tax rate cannot be applied instead.

R&TC §23051.5(h)(7) provides when applying any IRC section or any applicable regulation thereunder, due account shall be made for differences in federal and state terminology, effective dates and other obvious differences. CCR §19503 provides in the absence of regulations where the R&TC conforms to the IRC or Treas. Reg., when possible, govern the interpretation of conforming state statutes with due account for state terminology. This does not mean, however, that the California tax rate should be substituted for the federal rate in calculating the high foreign tax rule. Rather, it means that, in those cases where literal application of federal law is not possible because of federal/state differences, due account may be taken of those differences. Nothing in these sections suggests that a substantive change be made to a federal definition.

R&TC §25110 and the CCR thereunder refer to Subpart F income as defined in IRC §952. Although a separate election may be permissible for state purposes, substitution of the state for the federal rate is not allowable under the statute. "High tax jurisdiction" is a defined term under IRC §954(b), which is incorporated into California law. Substitution of the California rate would be tantamount to amending the federal definition for California purposes, contrary to the statutory prescription. (See *Appeal of AST Research, Inc.* Cal. St. Bd. of Equal., December 9, 1999, which, although it is an unpublished opinion and is not citable as authority, does provide insight into the Board's reasoning with respect to this issue.)

Both R&TC §25110 and the CCR thereunder require determination of Subpart F income under the federal rules. If a taxpayer makes the election for federal purposes, a certain result will occur. If a taxpayer does not make the election for federal purposes, but does elect for state, the same result should result as if the taxpayer had elected for federal purposes.

D. Anti-abuse Rule

There is an anti-abuse rule that applies to both the de minimis rule and the full inclusion rule. The income of two or more CFCs is

aggregated and treated as a single CFC if a principal purpose of forming multiple CFCs is to avoid the effect of these two rules.

Per Treas. Reg. §1.954-1(b)(4)(ii), avoidance is presumed if the CFCs are related corporations, and if either the:

1. Activities carried on, or the assets held, were previously carried on or held by a single CFC and the US shareholders are substantially the same.
2. CFCs carry on business, a financial operation or a venture as partners in a partnership that is related with respect to each CFC.
3. Activities carried on by the CFCs would constitute a single branch pursuant to IRC §367 if carried on by a US person.

c. Water's-Edge Application – Includable Activities of a CFC

1. In general

As mentioned above, a CFC with Subpart F income as defined in IRC §952 is included in the water's-edge combined report based on the ratio of Subpart F income to E&P for the current taxable year. (R&TC §25110(a)(2)(A)(ii).) The treatment of Subpart F income in the water's-edge combined report is substantially different than the treatment for federal purposes. For federal purposes, the US shareholder must report its pro-rata share of any Subpart F income as a deemed dividend and include in gross income. California does not conform to the federal Subpart F provisions. Rather, California uses the ratio of Subpart F income to current year E&P to measure how much of the CFC's income and apportionment factors are includible in the water's-edge combined report. Therefore, deemed dividends reported for federal purposes must still be excluded as a state adjustment, just as they would be for a worldwide combined report.

CCR §25110(d)(2)(E) provides for the inclusion of a CFC, as defined by IRC §957, which has Subpart F income, as defined by IRC §952, into the water's-edge group. The CFC must still meet the unitary standards to be included in the combined report. The includible income and apportionment factors are determined by multiplying the total income and apportionment factors (numerator and denominator) by a ratio equal to Subpart F income over current E&P.

2. CFC's Inclusion Ratio

The formulas used to calculate the inclusion of a CFC's income and factors are:

Income:

Subpart F income / Current E&P	x Total Net Business Income (Determined on a CA tax accounting basis.)	= Includible Business Income
Subpart F Income / Current E&P	x Nonbusiness Income (Determined on a CA tax accounting basis.)	= Includible Nonbusiness Income

Factors:

Subpart F Income / Current E&P	x Factors	= Includible Factors

CCR §25110(d)(2)(E) provides that the CFC inclusion ratio applies to both business and nonbusiness income. Once the inclusion ratio is determined, it is applied separately to business income, nonbusiness income, interest expense subject to the offset, and other items, which need to be included in the appropriate areas of the water's-edge combined report. The application of the ratio is not intended to change the character of business and nonbusiness income. CFCs with Subpart F income are only partially included in a water's-edge combined report. To determine the includible amounts of the CFC's California taxable income and apportionment factors, one must multiply these items by the ratio, the numerator of which is Subpart F income for the current year as defined by IRC §952, and the denominator of which is current year E&P as defined by IRC §964. (CCR §§25110(d)(2)(E)(2) and (4).)

Example

Corporation C, a CFC, has current year Subpart F income of $33,000, and current year E&P of $100,000. The CFC inclusion ratio to be used is computed as follows:

$$\frac{\text{Subpart F Income}}{\text{E\&P}} \quad \frac{\$33{,}000}{\$100{,}000} = 33\%$$

Assuming the following, these amounts are included in Corporation C's water's-edge combined report:

- Business Income Subject to Apportionment
  $120,000 x 33% = $39,600
- Nonbusiness Income
  $15,000 x 33% = $4,950
- Average Owned Property
  $150,000 x 33% = $49,500
- Rent to Capitalize
  $30,000 x 33% = $9,900
- Payroll
  $60,000 x 33% = $19,800
- Sales
  $180,000 x 33% = $59,400

Example

Corporation F, a CFC, has a ratio of Subpart F income to E&P of 1/4. Both Subpart F income and E&P 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.

Includible amounts for Corporation F in the water's-edge combined report are:

- Business Income Subject to Apportionment
  $1,000 x 25% = $250
- Nonbusiness Dividends Allocable Outside California
  $600 x 25% = $150
- Interest Expense
  $200 x 25% = $50

Application of these rules can result with the inclusion of a CFC with a loss, but only if it has positive current year E&P. If the CFC has no current year E&P, then none of the income and factors of the CFC are included in the water's-edge combined report. The inclusion ratio cannot exceed one, nor can it be less than zero. (CCR §25110(d)(2)(E)(2).)

As a result of the above limitation, if current year Subpart F income exceeds current year E&P, then the ratio is deemed to be one and 100

percent of the CFC's income and apportionment factor amounts would be included in the combined report. Because Subpart F income is always a positive number, when there is a current year E&P deficit, the ratio is deemed to be zero. None of the income or apportionment factor amounts would be included in the combined report.

A. Subpart F income (numerator of inclusion ratio)

The numerator of the inclusion ratio is Subpart F income as defined under IRC §952. For purposes of computing the numerator of the inclusion ratio, CCR §25110(d)(2)(E) provides that each type of income under IRC §952 shall apply in computing Subpart F income (numerator), such as foreign base company income (FBCI), insurance income, international boycott income, etc. This regulation also states that limitations and recharacterization provisions of IRC §952(c) shall not apply in computing Subpart F income, which include the following:

- Limited to current year E&P (although, CCR §25110(d)(2)(E) provides a similar limitation)
- Recharacterization in subsequent years
- Prior year deficits
- Qualified deficits from related parties

The regulation also specifically states that the exclusions and rules provided by IRC§954(b) shall apply, which include the following:

- De minimis rule
- Full inclusion rule
- High tax exception
- Deductions (directly, related party, other expenses)

See Chapter 2, section b for further discussion regarding Subpart F income (IRC § 952).

B. Current E&P (denominator of inclusion ratio)

CCR §25110(d)(2)(E) states that the denominator of the inclusion ratio shall equal the current year E&P of the CFC as defined by IRC §964. The E&P under IRC §964 is similar to the E&P calculation of a domestic corporation under IRC §964. For purposes of IRC §951 through §964 (Subpart F), Treas. Reg. §1.964-1(a) provides the general rules to be followed in computing E&P of a foreign corporation. The corporation must:

- ✓ Prepare a profit and loss (P&L) statement from the books of account regularly maintained by the corporation for accounting to its shareholders. (Treas. Reg. §1.964-1(a)(i).)

- ✓ Make adjustments necessary to conform the statement to US accounting standards (GAAP). (Treas. Reg. §1.964-1(a)(ii).)

- ✓ Make further adjustments to conform the statement to US tax concepts. (Treas. Reg. §1.964-1(a)(iii).)

- ✓ Translate the adjusted statement into US Dollars. (Treas. Reg. §1.964-(3) and IRC §986(b).)

- ✓ Adjust the amount of profit or loss shown on the translated statement for any exchange gain or loss. (Treas. Reg. §1.964(b)(1)(v) and IRC §988(b))

Unless material, no accounting or tax adjustments are required for failure to make adjustments conforming to US accounting standards

Current year E&P of the CFC is reported on federal form 5471, Schedules H (line 5d) and J (line 2). This number may not be the same as the amount reported on Schedule C of federal form 5471 since schedule C reports the net income per books. Schedule H starts with foreign book income. The adjustments made on lines 2 through 5 are required in order to conform the foreign income to US GAAP and US tax accounting principles.

See WEM 7 for a complete discussion related to E&P of a foreign corporation and see below for descriptions of adjustments reported on federal form 5471, Schedule H.

C. Differences between California and Federal

The following are commonly reported differences between the Subpart F income reported for federal purposes and the amount included in the numerator of the inclusion ratio.

- Shareholder's Pro-rata amount versus 100%

  The Subpart F income reported for federal purposes should represent the US shareholder's pro-rata ownership interest. The amount of Subpart F income reported on the US shareholder's Federal form 1120, Sch. C, should agree with the Subpart F income

reported on Schedule I of the federal form 5471. The amounts reported on Federal form 5471, Sch. I, represent the US shareholder's pro rata share.

For inclusion ratio purposes, all activities of the unitary CFC shall be considered. If the US shareholder owns less than 100 percent of the unitary CFC, the Subpart F income reported on Form 5471, sch. I, line 1, which equals the shareholder's pro rata share, shall be divided by the US shareholder's ownership percentages reported on federal form 5471, Box C of page 1 and Sch. B, column (e) in order to determine the total Subpart F income generated by the CFC. The total Subpart F income of the CFC is then divided by the current E&P of the CFC to determine the CFC's inclusion ratio.

Example: CFC1 generated $100,000 of Subpart F income. US shareholder1 owns 60% of CFC1 and is unitary. The other 40% is owned by unrelated parties. For federal purposes, the Subpart F income recognized by US shareholder1 equals $60,000 ($100,000 x 60% pro rate ownership). Such amount is reflected on Federal form 1120, Schedule C of the US shareholder1 and the CFC's federal form 5471, Schedule I, line 1. For inclusion ratio purposes, the full $100,000 is reported as the Subpart F income/numerator.

- IRC §§955 and 956

  Subpart F income for federal purposes may include amounts determined under IRC §§955 (Withdrawal of previously excluded Subpart F income from qualified investment) and 956 (Investment of earnings in US property). Such items are not included in the CFC's inclusion ratio. (CCR §25110(d)(2)(E)1.) If federal Subpart F income includes these amounts, then the Subpart F income must be reduced by the same amounts for purposes of calculating the California CFC inclusion ratio.

- Non-conformity to IRC §952(c)

  The numerator of the inclusion ratio is to include Subpart F income as defined by IRC §952, except that the provisions of IRC §952(c) shall not apply. The IRC §952(c) provisions that should not apply for California numerator purposes include the following:

- ✓ Recapture and recharacterization (IRC §952(c)(2) – Subpart F income for federal purposes may include amounts that were recharacterized in the current year from what is known as the recapture account. For federal purposes, Subpart F income that exceeds current year E&P is required to be recaptured and recharacterized as Subpart F income in future years when the current year E&P exceeds the Subpart F income. (IRC §952(c).) If the federal Subpart F income includes amounts that were recharacterized, then the Subpart F income must be reduced by the same amounts for purposes of calculating the California CFC inclusion ratio.

- ✓ Prior year deficit (IRC §952(c)(1)(B)) and qualified chain deficit rules (IRC §952(c)(1)(C)) – The prior year deficit or qualified chain deficit rule may have been used in the calculation of Subpart F income for federal purposes. Qualified deficits can be carried over to future years to reduce the current Subpart F income by reducing current year E&P. The qualified chain deficit rule is similar to the prior year deficit rule, except the deficits from qualified affiliates are used instead of the CFC's own deficits. (IRC §952(c).) If federal Subpart F income was reduced because of the prior year deficit rule or the qualified chain deficit rule, then Subpart F income must be increased by the same amounts for purposes of calculating the California CFC inclusion ratio.

- Computation of Inclusion Ratio – Example (Non-conformity to IRC §952(c).)

  In 2014, CFC, Inc. had a total of $100,000 of Subpart F income and $70,000 of current E&P. In 2015, CFC Inc. generated $80,000 of Subpart F income and current E&P of $100,000.

  - ✓ Subpart F income recognized for federal income tax purposes in 2014 equals $70,000. $100,000 of Subpart F income is limited to current E&P of $70,000. The remaining $30,000 of E&P will be recognized as Subpart F income in any subsequent year when E&P exceeds the Subpart F income generated in any subsequent year (pursuant to recharacterization rules provided by IRC §952(c) .
  - ✓ For 2014, the numerator/Subpart F income of the inclusion ratio shall equal $70,000. CCR §25110(d)(2)(E) specifically states that the fraction (inclusion ratio) shall not exceed one. The remaining $30,000 is not tracked for purposes of computing the

CA inclusion ratio. The inclusion ratio for 2014 equals 100% ($70,000 of Subpart F income over $70,000 of current earnings an profit)

- ✓ For 2015, Subpart F income recognized for federal income tax purposes equals $100,000; $80,000 of current Subpart F income plus $20,000 of prior year Subpart F income recharacterized, which equals $100,000. The remaining $10,000 of unrecognized Subpart F income from 2014 may be recognized in subsequent years.
- ✓ For 2015, the California inclusion ratio equals 80%; current Subpart F income of $80,000 over current E&P of $100,000. Since the recharacterization rules of IRC §952(c) do not apply for California franchise tax purposes, the numerator equals Subpart F income generated in the current year.

D. Other

1) Multi-Tiered CFCS and IRC §959(b)

When a CFC owns another CFC, the result in the corporate structure is referred to as "multi-tiered CFCs." For federal purposes, when a lower-tier CFC earns income that is treated as Subpart F income, the income is taxed as a "Subpart F" deemed dividend to the US shareholder even though this income is not currently distributed. If the earnings are subsequently distributed to a higher-tier CFC, then the dividend would qualify as Foreign Passive Holding Company Income (FPHCI) to the higher-tier CFC. But, if the dividend was paid out of previously taxed E&P, the dividend will not be included twice as Subpart F income to the US shareholder for federal purposes.

The dividend paid by a lower-tier CFC to a higher-tier CFC is not considered an "intercompany dividend" for federal tax purposes because CFCs are not included in the consolidated federal return. However, when a dividend is distributed from one CFC to another CFC, IRC §959(b) excludes those dividends from the recipient CFC's gross income to the extent that they are paid out of E&P that was previously taxed to the US shareholder as a Subpart F deemed dividend.

Thus, the federal rules allow a "look through" the CFC tiers to determine whether the dividend was paid from income previously taxed. If the dividend income has previously been included in the taxable income of the US shareholder, IRC §959(b) specifically

provides that the dividend is not included again as a deemed dividend pursuant to IRC §951.

Example

Calc USA owns 100 percent of Calc AG, a Swiss CFC, which owns 100 percent of Calc GmbH, a German CFC. During the taxable year, Calc GmbH earns $125,000, of which $86,000 qualifies as Subpart F income. During the taxable year, Calc AG has no income or investments other than the income that is derived from a distribution of $80,000 from Calc GmbH. Calc AG has E&P of $80,000 in the current taxable year. For federal purposes, Calc USA will report the following:

Answer: For federal purposes, in the taxable year, Calc USA is required to include $86,000 as a Subpart F deemed dividend (Calc GmbH's Subpart F income.) The $80,000 distribution received by Calc AG from Calc GmbH would constitute Subpart F income for Calc AG. However, by reason of IRC §959(b) and Treas. Reg. §1.959-2(a), the $80,000 does not constitute gross income for Calc AG for purposes of determining amounts includable in Calc USA's gross income pursuant to IRC §951(a)(1)(A)(i).

For California purposes, the tax treatment of this distribution is the same as the federal treatment. Refer to the Court of Appeal decision in *Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004), 120 Cal.App.4th 459 and FTB TAM 2005-01.) For purposes of computing the inclusion ratio for each CFC, the Subpart F income for Calc GMBH is $86,000, and the Subpart F income for Calc AG $0. (TAM 2005-01.)

Example

USA Corp owns 100 percent of Motors Holding, a Swiss CFC holding company. Motors Holding owns 100 percent of Motors Ltd., an Ireland corporation primarily engaged in manufacturing.

The lower-tier CFC, Motors Ltd. has Subpart F income of $10 million and current E&P of $100 million, which results in a 10 percent inclusion ratio. Motors Ltd., pays a dividend of $5 million to the higher-tier CFC, Motors Holding.

The high-tier CFC, Motors Holding, has Subpart F income of $25 million which includes $20 million from interest income it received during the year and $5 million dividend income from Motors Ltd. Motors Holding

has current E&P of $100 million, which includes $5 million dividend distribution from Motors Ltd. Motors Holding, pays a dividend of $10 million to USA Corp.

USA Corp, Motors Holding and Motors Ltd. have always filed on a unitary combined basis. The following explains what happens as a result of both Motors Holding and Motors Ltd. having Subpart F income and both distributing income.

Discussion and Answer:

For federal purposes:

Motors Ltd has Subpart F income of $10 million, which is a deemed dividend to USA Corp. Motors Holding has Subpart F income of $25 million. However, of this $25 million, $5 million is from a dividend paid by Motors Ltd., which is considered previously taxed income under IRC §959(b). Thus, the $5 million dividend has already been included in the US shareholder's income as a deemed dividend pursuant to IRC §951. As a result, pursuant to IRC §959(b), USA Corp only has to report $20 million as Subpart F income from Motors Holding. USA Corp received a dividend of $10 million from Motors Holding. Because this dividend is considered paid out of previously taxed E&P, the dividend is not included in USA Corp's income pursuant to IRC §959(a).

For California purposes:

Based on the ratio of Subpart F income over the current year E&P, Motors Ltd. is included in the water's-edge combined report 10 percent ($10,000,000 / $100,000,000 = 10%) and Motors Holding is included 20 percent ($20,000,000 / $100,000,000 = 20%.) Motors Holding's Subpart F income for inclusion ratio purposes does not include the $5 million dividend paid by Motors Ltd. (See TAM 2005-01.)

Note that in the example above, Motors Holding is a holding company, yet only 20 percent of its income is Subpart F income. If a CFC is truly a holding company, then its income should be passive in nature and should qualify as FPHCI. Perhaps question why the income is not FPHCI. The federal rules, to which California has not conformed, may be in use to eliminate the FPHCI from the Subpart F income.

2) CFC with US Source Income

Senate Bill (SB) 663, chaptered during May 2006, amended R&TC §25110 to clarify that if a CFC, which is a California taxpayer or has US source income, has both Subpart F income and US source income, both types of income are included in the water's-edge combined report. SB 663 is effective for taxable years beginning on or after January 1, 2006.

3. Includible Income of a CFC

A. Computation of CFC's Income

CCR §25106.5-10 governs the income and apportionment factors of combined reports, including foreign country operations, both worldwide and water's-edge. Three methods in determining the foreign corporation's income provided in the regulation are listed below.

1) CCR §25106.5-10(b)(1) specifically lists out the steps in computing a foreign corporation's income. See further discussion below.
2) Under CCR §25106.5-10(b)(2) a corporation may determine its income on the basis of the consolidated profit and loss statement prepared for filing with the Securities and Exchange Commission (SEC). If there is no filing with the SEC, a consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent audit may be used.
3) CCR§25106.5-10(e), referred to as the "reasonable approximation method," allows a reasonable approximation of income (and factors) to be used when the necessary data cannot be developed from the financial records maintained in the regular course of business.

CCR §25106.5-10(b)(1) provides the below described steps in determining income, subject to inclusion in the combined report pursuant to CCR §25110.

1. Prepare profit and loss statement in the currency which the books are regularly maintained

2. Make adjustments to conform book profit and loss statement to US generally accepted accounting principles (GAAP)
3. Make adjustments to conform to California R&TC (Division 2, Part 11, Corporate Tax Law)
4. Translate amount into the currency in which the parent company maintains its books and records
5. Identify and segregate business and nonbusiness income in accordance with CA law
6. Allocate nonbusiness income to a specific state
7. Include business income in the combined report that is prepared for the unitary business and apportion using the appropriate apportionment formula

The accounting and tax adjustments are only required if it is material. CCR §25106.5-10(b)(3)(C). Once determined, total income and all components of total income is multiplied by the inclusion ratio to determine the income that is includible in the CA combined report.

Accounting adjustments to conform the profit and loss statement to US GAAP include but are not limited to the following:

- Clear reflection of income – Any reporting that does not clearly reflect the current income and expenses for a taxable year shall be excluded. For example, any arbitrary reserve out of current income shall be excluded.
- Physical assets and depreciation - All physical assets, including inventory, shall be accounted for using the historical cost. Depreciation, depletion and amortization shall be based upon historical cost. International Foreign Accounting Standards (IFAS) provides for the revaluation of certain assets and such adjustments to be reflected in the expensing of such assets, which is not allowed under US GAAP.
- Valuation of Assets and liabilities – Some foreign countries, including IFAS, allows for the under valuation of assets or overvaluation of liabilities, which is not allowed under US GAAP. An example includes the write down of inventory below market value.
- Income equalization – Income and expenses shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or

similar provisions affecting income or expenses shall not be taken into account even though allowed under foreign law.
- Currency gains and losses on closed transactions are included in income. Unrealized gains and losses resulting from restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values shall not be included in income.

Tax accounting adjustments shall be made in order to report the income from a US GAAP/book basis to a tax basis that conforms to California R&TC and the regulations thereunder. Tax accounting adjustments shall include, but are not limited to, the following:

- Accounting methods – In accordance with R&TC §24651, generally the methods used should be same methods used for book (i.e., accrual, cash receipts and disbursements method, etc.).
- Inventories – R&TC §24701 shall apply, which conforms to IRC §§471 and 472, except as otherwise provided.
- Depreciation, depletion and amortization – These expenses shall be computed in accordance with CA R&TC.
- Elections – Elections required under CA R&TC (Part II, Div. 2) shall apply.

Common CA tax adjustments required under R&TC that are often reported by includible CFCs include the following:

- Gain/losses utilizing CA tax basis in assets transferred/sold (i.e., sale of stock)
- R&TC §24411 – Foreign dividend deduction
- R&TC §25106 – Intercompany dividend elimination
- R&TC §24345 - Taxes based upon income
- R&TC §24344 – Foreign investment interest offset (FIIO). The CFC's includible amounts (i.e., interest expense, foreign investments and total assets) shall be included in the combined computation of the FIIO.

Translating/Foreign currency. For purposes of determining income, translations shall be made at the exchange rates described below.

- Depreciation, depletion, or amortization shall be translated using the exchange rate reported for the period in which the historical costs of the underlying assets was incurred (or acquired).
- Income repatriated shall be translated using the exchange rate at the date of repatriation.
- All other items shall be translated using at either end-of-year exchange rate or at the simple average exchange rate for the translation period.

CCR §25106.5-10 states that total income shall exclude unrealized exchange rate gain/loss resulting from the restatement of assets and liabilities. This regulation also provides for the inclusion in net income of currency gains/losses on "closed" transactions. A "closed" transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the corporation maintains its books and records. For example, in the case of borrowing a foreign currency, the transaction is considered closed when payment has occurred.

B. Resources/Federal Form 5471

During the scoping and/or initial stages of the audit, Federal form 5471, Information Return of US Persons with Respect to Certain Foreign Corporations, should generally provide the information needed to compute and/or verify net income and apportionment factors. Form 5471 is an informational return that is not audited. If material amounts are reported that warrant further review and/or verification, other sources include, the general ledger, book to tax work-papers, E&P work-papers, etc.

Generally, a US person is required to file federal form 5471 reporting the activities of a foreign corporation when the US person owns 10% or more of the total value of the foreign corporation's stock and/or 10% or more of the total combined voting power of all stock in a foreign corporation.

For purposes of computing total income of the CFC that is subject to inclusion in the CA combined report, information reported on federal form 5471 is often used as the source. Below are brief

descriptions of the amounts reported on federal from 5471 that are often the basis and/or components for the CFC's total income.

1. Schedule C, Income Statement. This schedule generally computes the foreign book income using the functional currency. The left column (functional currency) represents the foreign book income using the functional currency. The column on the right (US dollars) represents the foreign book income translated into US dollars under US GAAP translation rules. Schedule C amounts may reflect net income based upon US GAAP (not just in translating to foreign currency but also in methods and principals), which occurs when the foreign books are maintained in functional currency in accordance with US GAAP.

   Schedule C, Line 18 represents net income or (loss) before extraordinary items, prior period adj., and the provisions for income, war profits and excess profits taxes (Sch. C, Line 19 for year 2018 forward).

2. Schedule H, Current Earnings and Profits. This schedule reports the foreign corporation's E&P for US tax purposes. Lines 1 through 5c are reported in functional currency and line 5d is reported in US dollars. The starting point for current E&P (line 1) begins with the current year net income or loss per the foreign books and reported in functional currency, which **includes** the deduction for taxes based upon income.

   Lines 2a – 2h includes certain adjustments (required by federal reg. 1.964-1) to determine the CFC's current E&P for US tax purposes. These adjustments are reported in functional currency and may include positive and negative adjustments to conform the foreign book income (reported on Schedule C, line 21) to US GAAP and to US tax accounting principles. Some of adjustments more commonly reported on Schedule H, lines 2a – 2h are briefly described below. The adjustments reported on lines 2a – 2h should be reviewed to determine if the amounts should be applied in determining net taxable income under CA R&TC.

Line 2a Capital gains or losses – Generally relates to differences in foreign book (Sch. C amounts) and E&P tax basis used to compute gain and losses. Adjustments may relate to differences in tax basis of depreciable property and tax basis of intangibles, such as stock. California's R&TC shall apply in determining tax basis in assets and capital gains and losses. For material amounts, a review of the work-papers detailing capital gain/loss, including tax basis detail, is recommended.

Line 2b and 2c Depreciation/amortization and depletion – This is a common adjustment reported. The adjustment is caused by differences in depreciable basis, methods and/or lives utilized for foreign book and federal E&P purposes. For foreign corporations with 20% or more of gross income from US sources, depreciation must be figured on a straight-line basis. (TR §1.312-15). CCR §25106.5-10(b)(3)(B) requires depreciation, depletion and amortization to be computed in accordance with CA R&TC.

Line 2e Charges to statutory reserves – adjustments may relate to foreign pension reserves and differences on what is an allowed deduction under federal E&P (i.e., IRC §404A) and foreign book (or US laws under ERISA). Bad debt adjustments are often reported on line 2e. In computing CA net income, CA R&TC shall apply in determining the proper adjustment(s).

Line 2f Inventory adjustments – Adjustment may relate to addition costs required to be capitalized as inventory for federal income tax purposes pursuant to IRC §263A. CA R&TC §2442.3 conforms to IRC §263A. Other adjustments may include write down of inventories to fair market value for foreign book purposes which is not allowed for federal E&P and/or additional gain on intercompany sale of inventory caused by such gain being deferred or eliminated for financial reporting purposes. As stated above, in computing net income for CA franchise tax purposes, CA R&TC §24701 shall apply, which conforms to IRC §471 and 472, except as otherwise provided.

Line 2g Taxes – Difference between taxes deducted for foreign book and federal E&P are reported on line 2g. CA R&TC §24345 shall be applied in determining if such taxes shall be deducted. Generally, any taxes paid or accrued based upon or measured by income or profits imposed by a government agency (municipal, county, city, state, territory, federal, etc.) or foreign county are not deducted in computing CA net income/total income. Schedule E of federal form 5471 should lists the income, war profits, and excess profits taxes paid or accrued.

Line 2h Foreign currency gains or losses – Adjustments related to Foreign exchange gain/losses resulting from differences between the foreign net income translated into functional currency using US GAAP translating methods (from Sch. C) and the differences between the functional currency amount of income tax expense (benefit) reported on Sch. C, line 20 and the amount of taxes that reduce or increase US E&P. As stated above, CA CCR §25106.5-10 states that income shall exclude unrealized exchange rate gain/loss resulting from the restatement of assets and liabilities and include in income any currency gains/losses on "closed" transactions.

Line 2i Other – Other adjustments related to foreign exchange gain/losses, contingency reveres, and product warranty are often reported on line 2h, among other adjustments. The CA R&TC shall be applied in computing total income of the CFC for California tax purposes.

Common methods used reflecting Federal form 5471 amounts.

There are a number of ways a CFC's total income can be computed as long as the end result equals income computed in accordance with the CA R&TC. Two common ways reported, utilizing federal form 5471 amounts, are reflected below. The two methods shown below reflect two different starting points with different adjustments, but generally should result in the same income.

Method 1 –

1) Start with federal form 5471, Sch. C, line 18 (Lin 19 for Tax Years 2018 forward), net income or loss before extraordinary items, prior period adjustments, and the provision for income, war profits, and excess profits taxes, in functional currency.

2) Identify adjustments reported on Schedule H, lines 2a – 2h, that would apply in computing income under CA R&TC and determine proper adjustment. For example, if material, a capital gain adjustment reported on line 2a related to the sale of stock should be adjusted to properly reflect capital gain/loss using CA tax basis in stock, not federal tax basis. Due to California's non-conformity, adjustments to stock basis for IRC §§1248 (deemed dividends) and 565 (consent dividends) will need to be excluded.

3) Determine any additional CA adjustments needed in order to properly report income in accordance with CA R&TC. Common adjustment reported includes the foreign dividend deduction (R&TC §24411) and any taxes measured by income that are often included on line 2g (R&TC §24345).

4) Translate net income to US dollars.

Method 2 –

1) Start with federal form 5471, Sch. H, line 5d. Current E&P in US dollars.

2) Identify adjustments from Schedule H, lines 2a – 2h, that would <u>not</u> apply and/or require adjustments in computing income under CA R&TC. In addition to the example provided in method 1, another example includes the exclusion of the foreign currency translation gains and losses reported on line 2h resulting from the translation of foreign book income under US GAAP translation methods (Sch. C, line 21, see discussion above). This adjustment should be translated to US dollar before excluding from line 5d.

3) Determine any additional CA adjustments in US dollars needed in order to properly report net income in accordance with CA R&TC. Common adjustments reported includes the foreign dividend deduction (R&TC §24411) and taxes measured by income (R&TC §24345).

4. Includible Apportionment Factors of a CFC

A. In General

CCR §25106.5-10(b)(1)(G) provides that the "[b]usiness income shall be included in the combined report and prepared for the unitary business and shall be apportioned on the basis of the appropriate formula for the business." For taxable years beginning on or after January 1, 2013, pursuant to R&TC §25128.7, only the receipts factor shall be used, unless R&TC §25128 applies. R&TC §25128 requires specified qualified business activities (i.e., banking and financial, etc.) to apportion business income using a 3 factor formula consisting of property, payroll and receipts.

The apportionment factors (numerator and denominator) of each includible CFC that are included in the combined report shall equal the CFC's inclusion ratio (Subpart F income/current E&P) multiplied by the numerator and denominator of each apportionment factor (i.e., receipts factor).

Inclusion ratio x everywhere receipts = includible everywhere receipts (denominator)

Inclusion ratio x CA receipts = includible CA receipts (numerator)

Unless otherwise specified in CCR §25106.5-10(c) (see discussion below), the CFC's apportionment factors subject to inclusion shall be based upon the general apportionment provisions found in R&TC. See Multistate Audit Technique Manual (MATM) for further guides in computing the apportionment factors.

B. Translation of Apportionment Factor Amounts/Values

The apportionment factors of a foreign corporation are generally similar to that of a domestic corporation, except for the additional rules provided by CCR §25106.5-10(c). CCR §25106.5-10(c)

provides additional rules related to currency and translating of the apportionment amounts/values, which are discussed below.

Receipts & Payroll Factors - Amounts shall be translated using the simple average of beginning and end of year exchange rates, unless there is a substantial fluctuation. If substantial fluctuation occurs, amounts shall be translated using a simple average of the monthly rates or a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

Property Factor – Fixed assets and inventories shall be valued at original cost and translated at the exchange rate as of the date of acquisition of the underlying asset. Rented property, capitalized at eight times its annual rental rate, shall be translated at the simple average of the beginning and end of year exchange rates.

For financial corporations, financial assets are translated at the year-end rate. Securities held, or reasonably expected to be held, for less than six months shall be translated at year-end rates. If a security is held, or reasonable expected to be held, for more than six months, it shall be translated at the appropriate rate for the translation period in which the historical cost of the asset is determined.

C. Other Considerations for Apportionment

In computing apportionment factors, the following items may be considered:

- Intercompany transactions shall be eliminated, pursuant to CCR §25110(e). These amounts (everywhere amounts) should be reported on Federal form 5471, Schedule M, Transactions between Controlled Foreign Corporation and Shareholders or Other Related Persons.

- If material amount of payroll is included in payroll factor, verify payroll is paid to employees of the CFC, in accordance with CCR §25132. In some countries, individuals performing services may be controlled by local government, as opposed to a US owned subsidiary.

d. California CFC Considerations

In some cases, a taxpayer may have hundreds of CFCs. An efficient approach is to list all CFCs that can be identified from the California return, the federal Form 1120, the federal Forms 5471, and the taxpayer's Annual Report.

Consider:

1. Unless the de minimis rule or the high foreign tax rule applies, in general, interest income should meet the definition of FPHCI. (IRC §§954(b)(3)(A) and 954(b)(4).)

2. If a CFC is listed as a holding company, then most of its income should be passive and meet the definition of FPHCI.

3. A CFC's operations may be classified as "manufacturing" on the federal Form 5471. If the federal Form 5471 states the CFC is a manufacturing company, the cost of goods sold schedule can be reviewed to determine what the percentage labor expense is in relation to total cost of goods sold. If the percentage is minimal or low, the classification as a manufacturer may be incorrect.

4. A CFC operating as a branch must properly apply the branch rules as referenced in IRC §954(d)(2).

5. For a CFC with a high percentage of its income qualifying as Subpart F income, the full inclusion rule can be applied to determine if the CFC should have been included 100 percent of its income as Subpart F income. (IRC §954(b)(3)(B).)

6. Consider the de minimis rule (IRC §954(b)(3)(A)) when determining if a CFC is includible in the water's-edge combined report, especially when the water's-edge tax return filed includes a CFC that shows a high inclusion ratio along with minimal net income and substantial property, payroll, or sales in a foreign country. If the de minimis rule applies, the CFC's income and the apportionment factors are properly excluded from the combined report.

7. If the taxpayer states that income is excluded from Subpart F income because of the high foreign tax rule, the taxpayer can substantiate the amount of foreign tax paid by providing the foreign tax return and proof of payment. (IRC §954(b)(4).)

8. Deductions are taken into account in determining FBCI. (IRC §954(b)(5).)

9. Consider whether the majority of the CFC's income consists of dividends. If so, R&TC §§25106 and 24411 must also be considered in determining the effects of inclusion.

10. There may be differences between what is reported on the federal Form 5471 as Subpart F income and what should be included in the numerator of the CFC inclusion ratio.

2.4 Water's-Edge Combined Reporting Considerations

a. In General
b. Domestic Corporations Owned Greater than 50 Percent
c. CFCs with Subpart F Income
d. US Source Income
e. US Activity Test

a. In General

An important step in commencing the examination of a taxpayer filing on a water's-edge basis or preparing a water's-edge report, is to ascertain all the members of the taxpayer's affiliated group. The identification of all affiliated entities, the percentage of ownership, type of entity (e.g., corporation, partnership, S corporation, etc.,) and location of incorporation (e.g., US or foreign) should be determined. Remember, to determine which entities are included in the water's-edge combined report, you first apply the unitary concept to identify unitary entities among the worldwide affiliated group.

Useful sources of information include:

- Annual Reports
- Articles of Incorporation (for incorporation locations)
- Charts of the Group Organizational Structure
- Company Websites
- Federal Forms 851, Affiliation Schedule (attached to the federal Form 1120. It identifies the included affiliates and ownership percentages.)
- Federal Forms 1042S, Foreign Person's US Source Income Subject to Withholding (This could identify foreign entities that have income subject to withholding, potentially US source income.)
- Federal Forms 1120
- Federal Forms 1120F
- Federal Forms 1120FSC
- Federal Forms 5471 (It identifies related foreign subsidiaries and ownership percentages.)
- Federal Forms 5472 (It identifies every foreign corporation that is engaged in a US trade or business, and foreign affiliates of domestic corporations owned or controlled 25 percent or more by a foreign person, if the foreign affiliate had transactions with the domestic corporation during its taxable year.)
- Financial Statements
- Lexis/Nexis Company files

- Prior Audit Reports
- Published Reference Materials, e.g., Moody's, Directory of Corporate Affiliates
- SEC Forms 10-K and 20F

Federal Form 1120 Information:

1. Obtain copies of all federal Forms 1120, 1120F and 1120FSC.

2. Compare the affiliates listed on the federal Form 851, Affiliation Schedule, to those companies included in the water's-edge combined report.

3. Review the federal Forms 5471 for identification of CFCs.

4. Review the federal Forms 5472 for identification of US source income.

Determine the status of any federal audit. Consider requesting copies of IRS Revenue Agent and IRS International Examiner IDRs, or an index to the federal IDRs. This would detail the specific issues being reviewed under the federal audit. For international issues, in addition to the specific issues, this would identify the CFCs being reviewed. Consider updating the progress of the federal audit should the IRS Revenue Agent or International Examiner change the scope of the issues being audited. Determine the effect to the California return and your examination.

b. Domestic Corporations Owned Greater Than 50 percent

1. Obtain all federal Forms 1120.
   a. Review ownership.
   b. Review business activity.

2. Reconcile with organizational chart.

3. Review Annual Reports or Financial Statements.

4. Review joint ventures.
   a. Determine if ownership/control is greater than 50 percent.
   b. Determine if the venture is in corporate form or is it a partnership. If in partnership form, the unitary activities should be included in the combined report regardless of ownership. (Pursuant to CCR §25137-1.)

c. CFCs with Subpart F Income

1. Review the federal Forms 5471.
   a. Determine where the CFC is incorporated.
   b. Determine the type of trade or business the CFC is engaged in.

2. Review Financial Statements of the CFC.

3. Secure the CFC's tax package.
   a. Determine what type of income the CFC earned.
   b. Determine what type of expenses the CFC incurred.
   c. Determine how the CFC calculate its reported Subpart F income for federal purposes.

4. Obtain CFC's income analysis by country.

5. Analyze US parent's intercompany account for reimbursements made on behalf of the CFC.

6. Analyze the effective tax rate in the CFC's country of incorporation.

7. Reconcile CFC's sales to reported sales to country of incorporation.

8. Reconcile with parent's organizational chart or listing and foreign investment account.

9. Consider the special rules (i.e., full inclusion, de minimis, high foreign tax, anti-abuse) and their effects on the Subpart F income.

10. Analyze the activity of a CFC with large apportionment factors and minimal income. Determine whether the CFC meets the de minimis rule.

d. US Source Income

1. Review the federal Forms 1120F.
   a. Determine the status of the foreign entity.
   b. Determine its trade or business.
   c. Determine the countries that are encompassed in its trade or business.
   d. Determine if it has an office or fixed place of business in the US. If so, determine where.
   e. Determine the types of income that are reported or reportable.
   f. Determine if US source income is reported.
   g. Determine if effectively connected income (ECI) reported on the federal Form 1120F, Section II.
   h. Review the items deemed non-effectively connected, reported on federal Form 1120F, Section I.
   i. Review Schedule M-1 detail to identify non-ECI.
   j. Review US affiliates intercompany transaction detail for payments made to the foreign affiliate (for taxable years beginning on or after January 1, 1992, the foreign affiliate should be included in the combined report if the payments received from the US affiliate constitute US source income under the IRC.)

2. Analyze balance sheet items to reconcile ECI and non-ECI with the US trade or business.

3. Review financial statements.

4. Analyze expenses attributed to the US income.

5. Determine if the foreign entity has sold US real property. (Federal Form 8288, US Withholding for Dispositions by Foreign Persons of US Real Property Interests.)

6. Determine if the foreign entity had income subject to withholding. (Federal Form 1042S, Foreign Person's US Source Income Subject to Withholding.)

7. For a US possession corporation (IRC §936), review the possession corporation's Federal 1120, Form 5735 (Possessions Corporation Tax Credit), Part I, to see if it reported gross income "from sources in the US."

e. US Activity Test

1. Review the federal Forms 1120F or 1120.
   a. Determine the entity's trade or business.
   b. Determine if it had an office or place of business. If so, determine the location.
   c. Determine if the taxpayer is claiming a treaty-based exemption for federal purposes. California does not follow the treaty provisions that limit federal ECI for such years. The taxpayer may not have a permanent establishment for treaty purposes, but the corporation's presence in the US may include property, payroll, or sales.

2. Review Financial Statements. Check for comments about offices or sales activities by geographic location.

3. Obtain detail by location of property, payroll and sales. When there is a geographic breakdown of property and sales in the annual report, request the detail on an entity-by-entity basis.

4. Review the General Ledger and the Trial Balance. Look for intercompany transactions and sales to unrelated third parties in the US.

5. Review sales invoices. Look for unrelated third party sales in the US.

6. Determine if the foreign corporation filed returns in any states. Obtain copies of the other state returns.

7. Obtain copies of fixed assets ledgers by entity.

8. Ask the taxpayer for reports on inventory by location to determine if there is inventory located in the US, such as a taxpayer operating in a Free or Foreign Trade Zones. Determine whether the entity, or any of its affiliates, has any activity in a Free or Foreign Trade Zone. Such activity could include property, payroll and sales in the US.

9. Request US payroll reports for US source payroll.