

AMENDED IN ASSEMBLY AUGUST 23, 2004

AMENDED IN SENATE MARCH 22, 2004

SENATE BILL

No. 1571

Introduced by Senator Alpert

February 19, 2004

An act to amend Section 25110 of the Revenue and Taxation Code, relating to taxation.

LEGISLATIVE COUNSEL'S DIGEST

SB 1571, as amended, Alpert. Bank and corporation taxes: water's-edge election: foreign affiliated corporations.

Existing law provides that, in the case of a business with income derived from or attributable to sources both within and without this state, the income is apportioned between this state and the other states and foreign countries for tax purposes in accordance with a specified formula based on the property, payroll, and sales within and without this state. Existing law permits a qualified taxpayer, as defined, to elect to determine its income under a water's-edge election. A water's-edge election provides that only the income and apportionment factors of certain described affiliated corporations may be included for purposes of determining the taxpayer's income apportioned to this state.

Existing law requires that income and apportionment factors of a foreign corporation be included in the combined report of a taxpayer making a water's-edge election, but only to the extent of the foreign corporation's United States-source income and apportionment factors. The income and apportionment factors of a controlled foreign corporation, as defined in the Internal Revenue Code, that is an affiliated corporation of a taxpayer are included in the combined report

of the taxpayer making a water’s-edge election to the extent of the “Subpart F” income ratio, as determined under existing law. Existing law, however, does not specify whether the United States-source income rules or the rules regarding “Subpart F” income, as defined in the Internal Revenue Code, apply to income of a controlled foreign corporation that has both United States-source income and Subpart F income.

This bill would clarify that existing law prohibits a controlled foreign corporation from excluding its Subpart F income from a water’s-edge combined report, even if it is a California taxpayer or has income from a United States source. This bill would also clarify that existing law requires inclusion in a water’s-edge combined report of both United States-source income and Subpart F income of a controlled foreign corporation, regardless of whether the corporation is a California taxpayer. This bill would declare that this clarification is operative for taxable years beginning on or after January 1, 2004. This bill would require the Franchise Tax Board to promulgate regulations to prevent the potential double taxation of income when a controlled foreign corporation has both United States-source income and Subpart F income.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

- 1 SECTION 1. Section 25110 of the Revenue and Taxation
- 2 Code is amended to read:
- 3 25110. (a) Notwithstanding Section 25101, a qualified
- 4 taxpayer, as defined in paragraph (2) of subdivision (b), that is
- 5 subject to the tax imposed under this part, may elect to determine
- 6 its income derived from or attributable to sources within this state
- 7 pursuant to a water’s-edge election in accordance with the
- 8 provisions of this part, as modified by this article. A taxpayer that
- 9 makes a water’s-edge election shall take into account that portion
- 10 of its own income and apportionment factors and the income and
- 11 apportionment factors of its affiliated entities (if any) to the extent
- 12 provided below:
- 13 (1) The entire income and apportionment factors of any of the
- 14 following corporations:



1 (A) Domestic international sales corporations, as described in
2 Sections 991 to 994, inclusive, of the Internal Revenue Code and
3 foreign sales corporations as described in Sections 921 to 927,
4 inclusive, of the Internal Revenue Code.

5 (B) Any corporation (other than a bank), regardless of the place
6 where it is incorporated if the average of its property, payroll, and
7 sales factors within the United States is 20 percent or more.

8 (C) Corporations that are incorporated in the United States,
9 excluding corporations making an election pursuant to Sections
10 931 to 936, inclusive, of the Internal Revenue Code.

11 (D) Export trade corporations, as described in Sections 970 to
12 972, inclusive, of the Internal Revenue Code.

13 (2) (A) With respect to a corporation that is not described in
14 subparagraph (A), (B), (C), or (D) of paragraph (1), as provided
15 in either one or both of the following clauses:

16 (i) The income and apportionment factors of that corporation
17 to the extent of its income derived from or attributable to sources
18 within the United States and its factors assignable to a location
19 within the United States in accordance with paragraph (3) of
20 subdivision (b). Income of that corporation derived from or
21 attributable to sources within the United States, as determined by
22 federal income tax laws, shall be limited to and determined from
23 the books of account maintained by the corporation with respect
24 to its activities conducted within the United States.

25 (ii) The income and apportionment factors of that corporation
26 that is a “controlled foreign corporation,” as defined in Section
27 957 of the Internal Revenue Code, to the extent determined by
28 multiplying the income and apportionment factors of that
29 corporation (without application of this subparagraph) by a
30 fraction (not to exceed one), the numerator of which is the
31 “Subpart F income” of that corporation for that taxable year and
32 the denominator of which is the “earnings and profits” of that
33 corporation for that taxable year.

34 (B) For purposes of this paragraph:

35 (i) “Subpart F income” means “Subpart F income” as defined
36 in Section 952 of the Internal Revenue Code.

37 (ii) “Earnings and profits” means “earnings and profits” as
38 described in Section 964 of the Internal Revenue Code.

39 (3) The income and apportionment factors of the corporations
40 described in this subdivision shall be taken into account only to the



1 extent that they would have been taken into account had no
2 election been made under this section.

3 (4) The Franchise Tax Board shall prescribe regulations to
4 coordinate the implementation of subparagraph (A) of paragraph
5 (2) to prevent multiple inclusion or exclusion of income and
6 factors in situations where the same item of income is described
7 in both clauses.

8 (b) For purposes of this article and Section 24411:

9 (1) An “affiliated corporation” means a corporation that is a
10 member of a commonly controlled group as defined in Section
11 25105.

12 (2) A “qualified taxpayer” means a corporation which does
13 both of the following:

14 (A) Files with the state tax return on which the water’s-edge
15 election is made a consent to the taking of depositions at the time
16 and place most reasonably convenient to all parties from key
17 domestic corporate individuals and to the acceptance of subpoenas
18 duces tecum requiring reasonable production of documents to the
19 Franchise Tax Board as provided in Section 19504 or by the State
20 Board of Equalization as provided in Title 18, California Code of
21 Regulations, Section 5005, or by the courts of this state as provided
22 in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4
23 of, and ~~Section 2025~~ *Chapter 9 (commencing with Section*
24 *2025.10) of Title 4 of Part 4* of, the Code of Civil Procedure. The
25 consent relates to issues of jurisdiction and service and does not
26 waive any defenses a taxpayer may otherwise have. The consent
27 shall remain in effect so long as the water’s-edge election is in
28 effect and shall be limited to providing that information necessary
29 to review or to adjust income or deductions in a manner authorized
30 under Sections 482, 861, Subpart F of Part III of Subchapter N, or
31 similar provisions of the Internal Revenue Code, together with the
32 regulations adopted pursuant to those provisions, and for the
33 conduct of an investigation with respect to any unitary business in
34 which the taxpayer may be involved.

35 (B) Agrees that for purposes of this article, dividends received
36 by any corporation whose income and apportionment factors are
37 taken into account pursuant to subdivision (a) from either of the
38 following are functionally related dividends and shall be presumed
39 to be business income:



1 (i) A corporation of which more than 50 percent of the voting
2 stock is owned, directly or indirectly, by members of the unitary
3 group and which is engaged in the same general line of business.

4 (ii) Any corporation that is either a significant source of supply
5 for the unitary business or a significant purchaser of the output of
6 the unitary business, or that sells a significant part of its output or
7 obtains a significant part of its raw materials or input from the
8 unitary business. “Significant,” as used in this subparagraph,
9 means an amount of 15 percent or more of either input or output.

10 All other dividends shall be classified as business or
11 nonbusiness income without regard to this subparagraph.

12 (3) The definitions and locations of property, payroll, and sales
13 shall be determined under the laws and regulations that set forth
14 the apportionment formulas used by the individual states to assign
15 net income subject to taxes on or measured by net income in that
16 state. If a state does not impose a tax on or measured by net income
17 or does not have laws or regulations with respect to the assignment
18 of property, payroll, and sales, the laws and regulations provided
19 in Article 2 (commencing with Section 25120) shall apply.

20 Sales shall be considered to be made to a state only if the
21 corporation making the sale may otherwise be subject to a tax on
22 or measured by net income under the Constitution or laws of the
23 United States, and shall not include sales made to a corporation
24 whose income and apportionment factors are taken into account
25 pursuant to subdivision (a) in determining the amount of income
26 of the taxpayer derived from or attributable to sources within this
27 state.

28 (4) “The United States” means the 50 states of the United
29 States and the District of Columbia.

30 (c) All references in this part to income determined pursuant to
31 Section 25101 shall also mean income determined pursuant to this
32 section.

33 SEC. 2. (a) The amendments made to Section 25110 of the
34 Revenue and Taxation Code by this act shall be applied to taxable
35 years beginning on or after January 1, 2004.

36 (b) It is the intent of the Legislature that no inference be drawn
37 in connection with any matter governed by Section 25110 of the
38 Revenue and Taxation Code for any taxable year beginning before



- 1 January 1, 2004, with respect to the amendments made to Section
- 2 25110 of the Revenue and Taxation Code by this act.

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