

AMENDED IN ASSEMBLY JUNE 20, 2005

AMENDED IN ASSEMBLY APRIL 4, 2005

CALIFORNIA LEGISLATURE—2005—06 REGULAR SESSION

**ASSEMBLY BILL**

**No. 34**

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**Introduced by Assembly Member Ruskin  
(Principal coauthor: Assembly Member Jerome Horton)  
(Coauthor: Senator Ortiz)**

December 6, 2004

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An act to amend Section 25110 of the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 34, as amended, Ruskin. Corporation tax: water's-edge election: tax havens.

The Corporation Tax Law imposes taxes measured by income and, in the case of a business with income derived from or attributable to sources both within and without this state, apportions the income between this state and other states and foreign countries in accordance with a specified 4-factor formula based on the property, payroll, and sales within and without this state, except as otherwise provided. That law allows corporations to elect whether their income is determined on a "water's-edge" basis or on a worldwide unitary basis. In general, a corporation that makes a water's-edge election is subject to tax on income only from sources within the United States but is required to take into account the income and apportionment factors of certain specified affiliated entities.

This bill would expand the list of specified affiliated entities to include a corporation that is incorporated, headquartered, or located in

a tax haven country, as defined, *and would make related legislative findings and declarations.*

This bill would also require the Legislative Analyst, in consultation with the Franchise Tax Board, to conduct a study regarding the jurisdictions identified by the Organization for Economic Cooperation and Development (OECD) as tax havens and to report to the Legislature, no later than January 1, ~~2008~~ 2010, as to whether the definition of the term “tax haven” should be revised.

This bill would result in a change in state taxes for the purpose of increasing state revenues within the meaning of Section 3 of Article XIII A of the California Constitution, and thus would require for passage the approval of  $\frac{2}{3}$  of the membership of each house of the Legislature.

This bill would take effect immediately as a tax levy, *but will be operative for taxable years beginning on or after January 1, 2006.*

Vote:  $\frac{2}{3}$ . Appropriation: no. Fiscal committee: yes.  
State-mandated local program: no.

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

- 1     SECTION 1. (a) *The Legislature finds and declares all of the*  
2 *following:*  
3     (1) *The sheltering of income in offshore tax haven countries*  
4 *has been a major means of tax avoidance for multinational*  
5 *corporations.*  
6     (2) *In many cases the sheltering occurs because income that*  
7 *should be properly attributed to activities in the United States is*  
8 *being attributed to those tax haven countries.*  
9     (3) *The water’s-edge election provisions enacted by California*  
10 *addressed these concerns by requiring that some foreign*  
11 *incorporated entities be included within a corporate taxpayer’s*  
12 *water’s-edge combined report. However, additional strategies*  
13 *have been developed by multinational corporations to assign*  
14 *income to foreign incorporated entities that perform limited*  
15 *economic activity in those countries and are not included within*  
16 *the water’s-edge combined report.*  
17     (b) *It is the intent of the Legislature, therefore, in enacting this*  
18 *section, to further limit the ability of multinational corporations*  
19 *to use tax haven countries to exclude income from the*  
20 *water’s-edge combined report as a means of domestic tax*

1 avoidance, to the extent that such income is not derived from, or  
2 attributable to, substantial economic presence or significant  
3 economic activity in the tax haven country.

4 (c) In granting regulatory authority to the Franchise Tax  
5 Board with regard to a determination of whether a corporation  
6 has established a substantial economic presence or conducts  
7 significant economic activity in a tax haven country, the  
8 Legislature intends that the Franchise Tax Board examine  
9 whether economic factors, including payroll and property, are  
10 located in the tax haven in a manner proportionate to the income  
11 attributable to the tax haven.

12 ~~SECTION 1.—~~

13 SEC. 2. Section 25110 of the Revenue and Taxation Code is  
14 amended to read:

15 25110. (a) Notwithstanding Section 25101, a qualified  
16 taxpayer, as defined in paragraph (2) of subdivision (b), that is  
17 subject to the tax imposed under this part, may elect to determine  
18 its income derived from or attributable to sources within this  
19 state pursuant to a water's-edge election in accordance with the  
20 provisions of this part, as modified by this article. A taxpayer that  
21 makes a water's-edge election shall take into account the income  
22 and apportionment factors of the following affiliated entities  
23 only:

24 (1) Domestic international sales corporations, as described in  
25 Sections 991 to 994, inclusive, of the Internal Revenue Code and  
26 foreign sales corporations as described in Sections 921 to 927,  
27 inclusive, of the Internal Revenue Code.

28 (2) Any corporation (other than a bank), regardless of the  
29 place where it is incorporated, if the average of its property,  
30 payroll, and sales factors within the United States is 20 percent or  
31 more.

32 (3) Corporations that are incorporated in the United States,  
33 excluding corporations making an election pursuant to Sections  
34 931 to 936, inclusive, of the Internal Revenue Code, of which  
35 more than 50 percent of their voting stock is owned or controlled  
36 directly or indirectly by the same interests.

37 (4) A corporation that is not described in paragraphs (1) to (3),  
38 inclusive, or paragraph (5), but only to the extent of its income  
39 derived from or attributable to sources within the United States  
40 and its factors assignable to a location within the United States in

1 accordance with paragraph (3) of subdivision (b). Income of that  
2 corporation derived from or attributable to sources within the  
3 United States as determined by federal income tax laws shall be  
4 limited to and determined from the books of account maintained  
5 by the corporation with respect to its activities conducted within  
6 the United States.

7 (5) Export trade corporations, as described in Sections 970 to  
8 972, inclusive, of the Internal Revenue Code.

9 (6) Any affiliated corporation which is a “controlled foreign  
10 corporation,” as defined in Section 957 of the Internal Revenue  
11 Code, if all or part of the income of that affiliate is defined in  
12 Section 952 of Subpart F of the Internal Revenue Code (“Subpart  
13 F income”). The income and apportionment factors of any  
14 affiliate to be included under this paragraph shall be determined  
15 by multiplying the income and apportionment factors of that  
16 affiliate without application of this paragraph by a fraction (not  
17 to exceed one), the numerator of which is the “Subpart F  
18 income” of that corporation for that taxable year and the  
19 denominator of which is the “earnings and profits” of that  
20 corporation for that taxable year, as defined in Section 964 of the  
21 Internal Revenue Code.

22 (7) (A) Subject to subparagraph (B), for taxable years  
23 beginning on or after January 1, ~~2005~~ 2006, any corporation that,  
24 for any portion of the taxable year, was doing business in, or had  
25 income derived from or attributable to, a tax haven.

26 ~~(B) If the corporation can establish that its business activity in,  
27 or income derived from or attributable to, a tax haven constitutes  
28 either a substantial economic presence or significant economic  
29 activity in that jurisdiction, the Franchise Tax Board may treat  
30 the activity and income of that corporation as not having been  
31 conducted in, or derived from or attributable to, the tax haven.~~

32 *(B) If the application of subparagraph (A) results in the  
33 inclusion of a business activity in, or income derived from or  
34 attributable to, a tax haven that constitutes either a substantial  
35 economic presence or significant economic activity in that  
36 jurisdiction, the taxpayer may petition the Franchise Tax Board  
37 to treat the activity and income of that corporation or activity as  
38 not having been conducted in, or derived from or attributable to,  
39 the tax haven.*

1 (C) The Franchise Tax Board shall prescribe ~~necessary and~~  
2 ~~appropriate regulations~~ *any regulations that may be necessary or*  
3 *appropriate* to carry out the purposes of the amendments made to  
4 this section by the act adding this subparagraph, *including*  
5 *regulations prescribing the extent to which an activity in, or*  
6 *income derived from or attributable to, a tax haven will be*  
7 *presumed to be either a substantial economic presence or*  
8 *significant economic activity, and the extent to which income will*  
9 *be presumed to be not derived from or attributable to a tax*  
10 *haven.*

11 (8) (A) The income and factors of the above-enumerated  
12 corporations shall be taken into account only if the income and  
13 factors would have been taken into account under Section 25101  
14 if this section had not been enacted.

15 (B) The income and factors of a corporation that is not  
16 described in paragraphs (1) to (3), inclusive, and paragraph (5)  
17 and that is an electing taxpayer under this subdivision shall be  
18 taken into account in determining its income only to the extent  
19 set forth in paragraph (4).

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

21 (1) An “affiliated corporation” means a corporation that is a  
22 member of a commonly controlled group as defined in Section  
23 25105.

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

26 (A) Files with the state tax return on which the water’s-edge  
27 election is made a consent to the taking of depositions at the time  
28 and place most reasonably convenient to all parties from key  
29 domestic corporate individuals and to the acceptance of  
30 subpoenas duces tecum requiring reasonable production of  
31 documents to the Franchise Tax Board as provided in Section  
32 19504 or by the State Board of Equalization as provided in Title  
33 18, California Code of Regulations, Section 5005, or by the  
34 courts of this state as provided in Chapter 2 (commencing with  
35 Section 1985) of Title 3 of Part 4 of, and Section 2025 of, the  
36 Code of Civil Procedure. The consent relates to issues of  
37 jurisdiction and service and does not waive any defenses a  
38 taxpayer may otherwise have. The consent shall remain in effect  
39 so long as the water’s-edge election is in effect and shall be  
40 limited to providing that information necessary to review or to

1 adjust income or deductions in a manner authorized under  
2 Sections 482, 861, Subpart F of Part III of Subchapter N, or  
3 similar provisions of the Internal Revenue Code, together with  
4 the regulations adopted pursuant to those provisions, and for the  
5 conduct of an investigation with respect to any unitary business  
6 in which the taxpayer may be involved.

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

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

15 (ii) Any corporation that is either a significant source of  
16 supply for the unitary business or a significant purchaser of the  
17 output of the unitary business, or that sells a significant part of its  
18 output or obtains a significant part of its raw materials or input  
19 from the unitary business. “Significant,” as used in this  
20 subparagraph clause, means an amount of 15 percent or more of  
21 either input or output.

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

24 (3) (A) For purposes of this section, a “tax haven” means any  
25 of the 39 jurisdictions that, as of December of 2002, were  
26 identified as tax havens by the Organization for Economic  
27 Cooperation and Development (OECD).

28 (B) The Franchise Tax Board shall issue a notice identifying  
29 the jurisdictions that are tax havens for purposes of this section.

30 (C) The Legislative Analyst, in consultation with the  
31 Franchise Tax Board, shall conduct a study regarding the  
32 jurisdictions identified by the OECD as tax havens and shall  
33 report to the Legislature, no later than January 1, ~~2008~~ 2010, as  
34 to whether the definition of the term “tax haven” should be  
35 revised.

36 (4) The definitions and locations of property, payroll, and  
37 sales shall be determined under the laws and regulations that set  
38 forth the apportionment formulas used by the individual states to  
39 assign net income subject to taxes on or measured by net income  
40 in that state. If a state does not impose a tax on or measured by

1 net income or does not have laws or regulations with respect to  
2 the assignment of property, payroll, and sales, the laws and  
3 regulations provided in Article 2 (commencing with Section  
4 25120) shall apply.

5 Sales shall be considered to be made to a state only if the  
6 corporation making the sale may otherwise be subject to a tax on  
7 or measured by net income under the Constitution or laws of the  
8 United States, and shall not include sales made to a corporation  
9 whose income and apportionment factors are taken into account  
10 pursuant to subdivision (a) in determining the amount of income  
11 of the taxpayer derived from or attributable to sources within this  
12 state.

13 (5) "The United States" means the 50 states of the United  
14 States and the District of Columbia.

15 (c) All references in this part to income determined pursuant to  
16 Section 25101 shall also mean income determined pursuant to  
17 this section.

18 ~~SEC. 2.~~

19 SEC. 3. This act provides for a tax levy within the meaning  
20 of Article IV of the Constitution and shall go into immediate  
21 effect.