

AMENDED IN ASSEMBLY MAY 26, 2005

CALIFORNIA LEGISLATURE—2005—06 REGULAR SESSION

**ASSEMBLY BILL**

**No. 441**

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**Introduced by Assembly Member Chu**

February 15, 2005

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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 441, as amended, Chu. Corporation taxes: water's-edge election: inverted corporations.

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.

This bill would require a corporation that makes a water's-edge election to include the income and apportionment factors of its affiliated foreign incorporated entity that is treated as an inverted domestic corporation, as defined.

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 XIIA 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.

Vote: 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. The Legislature finds and declares all of the  
2 following:

3 (a) A number of publicly traded United States domiciled  
4 corporations that are subject to a water’s-edge election are  
5 becoming “inverted domestic corporations” in order to avoid  
6 their fare share of California taxation.

7 (b) An “inverted domestic corporation” is a corporation that  
8 changes the country of its legal domicile to a domicile located  
9 outside of the United States. One of the results of this change  
10 may be tax reporting advantages. In substance, these transactions  
11 are essentially “paper transactions” that have no significant effect  
12 on the business operations of the taxpayers involved. Typically,  
13 the inverted corporation has no substantial business presence in  
14 the country of its new domicile.

15 (c) Under the water’s-edge election rules, a domestic  
16 corporation includes all of its worldwide income in the  
17 water’s-edge group, while much of a foreign corporation’s  
18 income is excluded from income of the group. If the foreign  
19 status of an inverted domestic corporation is respected, the  
20 inverted domestic corporation can remove a large portion of its  
21 worldwide income from the California tax base of the  
22 water’s-edge group, without changing any of its operations in  
23 any material respect, and therefore, significantly reduce the net  
24 income on which California’s share of corporate income is  
25 calculated and taxed.

26 (d) Treating an inverted domestic corporation as if it retained  
27 its status as a United States domiciled corporation for purposes of  
28 a water’s-edge election would stem the loss of corporate tax  
29 revenue.

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

32 25110. (a) Notwithstanding Section 25101, a qualified  
33 taxpayer, as defined in paragraph (2) of subdivision (b), that is  
34 subject to the tax imposed under this part, may elect to determine

1 its income derived from or attributable to sources within this  
2 state pursuant to a water’s-edge election in accordance with the  
3 provisions of this part, as modified by this article. A taxpayer that  
4 makes a water’s-edge election shall take into account the income  
5 and apportionment factors of the following affiliated entities  
6 only:

7 (1) Domestic international sales corporations, as described in  
8 Sections 991 to 994, inclusive, of the Internal Revenue Code and  
9 foreign sales corporations as described in Sections 921 to 927,  
10 inclusive, of the Internal Revenue Code.

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

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

20 (B) An inverted domestic corporation.

21 (4) A corporation that is not described in paragraphs (1) to (3),  
22 inclusive, or paragraph (5), but only to the extent of its income  
23 derived from or attributable to sources within the United States  
24 and its factors assignable to a location within the United States in  
25 accordance with paragraph (3) of subdivision (b). Income of that  
26 corporation derived from or attributable to sources within the  
27 United States as determined by federal income tax laws shall be  
28 limited to and determined from the books of account maintained  
29 by the corporation with respect to its activities conducted within  
30 the United States.

31 (5) Export trade corporations, as described in Sections 970 to  
32 972, inclusive, of the Internal Revenue Code.

33 (6) Any affiliated corporation which is a “controlled foreign  
34 corporation,” as defined in Section 957 of the Internal Revenue  
35 Code, if all or part of the income of that affiliate is defined in  
36 Section 952 of Subpart F of the Internal Revenue Code (“Subpart  
37 F income”). The income and apportionment factors of any  
38 affiliate to be included under this paragraph shall be determined  
39 by multiplying the income and apportionment factors of that  
40 affiliate without application of this paragraph by a fraction (not

1 to exceed one), the numerator of which is the “Subpart F  
2 income” of that corporation for that taxable year and the  
3 denominator of which is the “earnings and profits” of that  
4 corporation for that taxable year, as defined in Section 964 of the  
5 Internal Revenue Code.

6 (7) (A) The income and factors of the above–enumerated  
7 corporations shall be taken into account only if the income and  
8 factors would have been taken into account under Section 25101  
9 if this section had not been enacted.

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

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

16 (1) (A) An “affiliated corporation” means a corporation that is  
17 a member of a commonly controlled group as defined in Section  
18 25105.

19 (B) An “inverted domestic corporation” means a foreign  
20 incorporated entity, as defined in clause (iii) of subparagraph (C),  
21 if all of the following apply:

22 (i) Either subclause (I) or (II) applies:

23 (I) The foreign incorporated entity acquires, directly or  
24 indirectly, substantially all of the properties held, directly or  
25 indirectly, by a domestic corporation or substantially all of the  
26 properties constituting a trade or business of a domestic  
27 partnership or a related foreign partnership, and immediately  
28 after the acquisition, either:

29 (aa) In the case of a domestic corporation, more than 50  
30 percent of the stock, by vote or value, of the foreign incorporated  
31 entity is held by former shareholders of the domestic corporation  
32 by reason of holding stock in the domestic corporation.

33 (ab) In the case of a domestic partnership, more than 50  
34 percent of the stock, by vote or value, of the foreign incorporated  
35 entity is held by former partners of the domestic partnership or  
36 related foreign partnership by reason of holding a capital or  
37 profits interest in the domestic partnership or related foreign  
38 partnership.

39 (II) The foreign incorporated entity acquires, directly or  
40 indirectly, substantially all of the properties held, directly or

1 indirectly, by a domestic corporation or substantially all of the  
2 properties constituting a trade or business of a domestic  
3 partnership or a related foreign partnership, and more than 50  
4 percent of the stock, by vote or value, of the foreign incorporated  
5 entity is held by domestic shareholders.

6 (ii) Immediately after the acquisition described in clause (i),  
7 the properties acquired constitute at least 80 percent of the assets  
8 of the foreign incorporated entity.

9 (C) (i) In applying subparagraph (B), the following rules  
10 apply:

11 (I) There shall not be taken into account, in determining  
12 ownership for purposes of subclause (I) of clause (i) of  
13 subparagraph (B), either of the following:

14 (aa) Stock held by members of the expanded affiliated group  
15 that includes the foreign incorporated entity.

16 (ab) Stock of that foreign incorporated entity that is sold in a  
17 public offering related to the acquisition described in  
18 subparagraph (B).

19 (II) If a foreign incorporated entity acquires, directly or  
20 indirectly, substantially all of the property of a domestic  
21 corporation or partnership during a four-year period and the  
22 ownership requirements of clause (i) of subparagraph (B) are met  
23 within two years from the date of that acquisition, then that  
24 acquisition shall be treated as having been made pursuant to a  
25 plan.

26 (III) The transfer of property or liabilities, including by  
27 contribution or distribution shall be disregarded if the transfers  
28 are part of a plan, a principal purpose of which is to avoid the  
29 purposes of this section.

30 (IV) For purposes of applying subparagraph (B) to the  
31 acquisition of a domestic partnership, all domestic partnerships  
32 that are under common control within the meaning of Section  
33 482 of the Internal Revenue Code shall, except as otherwise  
34 provided in regulations prescribed by the Franchise Tax Board,  
35 be treated as a partnership.

36 (V) The Franchise Tax Board may prescribe those regulations  
37 as may be necessary to do both of the following:

38 (aa) Treat warrants, options, contracts to acquire stock,  
39 convertible debt instruments, and other similar interest or  
40 intangibles as stock.

1 (ab) Treat stock as not stock.

2 (ii) Notwithstanding subparagraph (A), for purposes of  
3 subparagraph (B) the term “expanded affiliated group” means an  
4 affiliated group as defined in Section 1504(a) of the Internal  
5 Revenue Code, without regard to Section 1504(b)(3) of the  
6 Internal Revenue Code, except that Section 1504 of the Internal  
7 Revenue Code shall be applied by substituting “more than 50  
8 percent” for “at least 80 percent” each place it appears.

9 (iii) The term “foreign incorporated entity” means any entity  
10 that is treated as a foreign corporation for purposes of the Internal  
11 Revenue Code.

12 (iv) (I) Except as provided in subclause (II), the terms  
13 “person,” “domestic,” and “foreign” have the meanings given  
14 those terms by paragraphs (1), (4), and (5), respectively, of  
15 Section 7701(a) of the Internal Revenue Code.

16 (II) For purposes of this article and the application of  
17 provisions of the Internal Revenue Code applicable for purposes  
18 of this article, including Subpart F of the Internal Revenue Code,  
19 a foreign incorporated entity that is an inverted domestic  
20 corporation shall be treated as a domestic corporation.

21 (v) For purposes of this section, indirect acquisition of  
22 property includes the acquisition of stock of the owner of that  
23 property.

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 Chapter 9 (commencing  
36 with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil  
37 Procedure. The consent relates to issues of jurisdiction and  
38 service and does not waive any defenses a taxpayer may  
39 otherwise have. The consent shall remain in effect so long as the  
40 water’s-edge election is in effect and shall be limited to

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

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

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

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

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

25 (3) The definitions and locations of property, payroll, and  
26 sales shall be determined under the laws and regulations that set  
27 forth the apportionment formulas used by the individual states to  
28 assign net income subject to taxes on or measured by net income  
29 in that state. If a state does not impose a tax on or measured by  
30 net income or does not have laws or regulations with respect to  
31 the assignment of property, payroll, and sales, the laws and  
32 regulations provided in Article 2 (commencing with Section  
33 25120) shall apply.

34 Sales shall be considered to be made to a state only if the  
35 corporation making the sale may otherwise be subject to a tax on  
36 or measured by net income under the Constitution or laws of the  
37 United States, and shall not include sales made to a corporation  
38 whose income and apportionment factors are taken into account  
39 pursuant to subdivision (a) in determining the amount of income

1 of the taxpayer derived from or attributable to sources within this  
2 state.

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

5 (c) All references in this part to income determined pursuant to  
6 Section 25101 shall also mean income determined pursuant to  
7 this section.

8 (d) The amendments made to this section by the act adding  
9 this subdivision apply as follows:

10 (1) To a taxpayer that is required to file on a water’s-edge  
11 basis in its first taxable year beginning on or after January 1,  
12 2005, pursuant to a water’s-edge election *made* in accordance  
13 with the provisions of this part, as modified by this article, made  
14 on or after January 1, 2005.

15 (2) To a taxpayer that is required to file on a water’s-edge  
16 basis pursuant to a water’s-edge election *made* in accordance  
17 with the provisions of this part, as modified by this article, made  
18 in a year prior to January 1, 2005, under Section 25111 *or*  
19 *Section 25113*, in its first taxable year beginning on or after  
20 January 1 of the *taxable* year ~~immediately succeeding the~~  
21 ~~expiration of the term of the water’s-edge contract in effect on~~  
22 ~~January 1, 2005.~~ *succeeding 84 months after the commencement*  
23 *of the taxpayer’s water’s-edge election.*

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

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