Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Ridley-Thomas	Analyst:	Gail Hall	Bill Number:	AB 2829
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 24, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Water's-Edge Election/Inverted Corporations

SUMMARY

This bill would provide that certain foreign-based entities remain subject to California tax after a corporate restructure.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to ensure that inverted domestic entities (i.e., former U.S. based corporations and partnerships that have converted themselves to foreign-country based corporations) pay their fair share of California taxes.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment and would specifically apply to taxable years beginning on or after January 1, 2006, for corporations making a water's-edge election on or after January 1, 2006, and for corporations that made an election before January 1, 2006, where that water's-edge election is in effect but not until the expiration of the seven-year period during which a taxpayer may not terminate that election without the consent of the Franchise Tax Board.

POSITION

Pending.

ANALYSIS

FEDERAL LAW

Current federal law applies special tax rules to corporations that undertake certain defined corporate inversions. A corporate inversion is a transaction through which the U.S. corporation becomes a subsidiary of a new foreign incorporated entity. The new foreign corporation, typically located in a low or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group.

Board Position:			Department Director	Date
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Internal Revenue Code (IRC) Section 7874 was added as a result of the American Jobs Creation Act of 2004 and contains provisions to remove incentives for entering into corporate inversions. This section provides that a foreign corporation is treated as a U.S. corporation for all purposes of the IRC where, under a plan or series of related transactions:

- the foreign corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all the properties held directly or indirectly by a U.S. corporation,
- the U.S. shareholders obtain 80% or more of the foreign corporation's stock, and
- the foreign corporation, and corporations connected to it by a 50% chain of ownership, do not have substantial business activities in the foreign corporation's country of incorporation or organization when compared to the business activities of the group.

The same rules apply where a domestic partnership transfers substantially all the properties of a trade or business to a foreign corporation and the same stock ownership and absence of business activities test (second and third bullet) are met.

STATE LAW

California does not conform to the federal corporate inversion law discussed above. To understand why this bill is necessary, one must understand California's general rules for taxing corporations, which are provided below.

A taxpayer that operates both within and without the state may use the worldwide or water's-edge method of filing its state tax return.

Worldwide Method

If a taxpayer uses the worldwide unitary method to file its state taxes, its business income from both domestic and foreign operations is considered in the calculation of state tax. A share of that income is "apportioned" to California. The amount to be apportioned to California is determined on the basis of a formula. The formula measures relative levels of business activity in the state using the amounts of the taxpayer's property, payroll, and sales in California. These measures of activities are commonly called "factors." The factors from both domestic and foreign activities are included in the calculation of the apportionment formula.

Under the worldwide method of reporting, "where" a taxpayer is incorporated (i.e., foreign or domestic) generally does not have a material effect on the California tax liability of the taxpayer. This is because both domestic and foreign business income and apportionment factors are included in the calculation of California tax under the worldwide method.

Water's-Edge

As an alternative to the worldwide method, California law allows corporations to elect to determine their business income on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. The business income is then apportioned to California based on the formula discussed in the "Worldwide" section above.

For taxable years beginning on or after January 1, 2003, the manner of making a water's-edge election substantially changed. The new law replaced the water's-edge contract with a statutory election that continues in effect for a minimum of 84 months (seven years).

A water's-edge election must be for an initial term of 84 months and remains in effect thereafter, year to year, until terminated by the taxpayer. If a taxpayer terminates its water's-edge election, it is required to file on a worldwide basis for at least 84 months before making another water's-edge election. Corporations that made a valid election for taxable years beginning before January 1, 2003, will continue to file on a water's-edge basis, will be deemed to have elected under the new election law, and will keep their original water's-edge election commencement date that is used to calculate the 84 month term.

Any affiliated corporation that is a Controlled Foreign Corporation (CFC) for federal tax purposes is partially included in the water's-edge combined report, if it is unitary with the water's-edge members and has subpart F income. A CFC is a foreign corporation that is owned more than 50% by U.S. shareholders. In general, the income and apportionment factors of the CFC are included in the water's-edge tax return based on a ratio, the numerator of which is the CFC's subpart F income for federal purposes for the current year and the denominator of which is the CFC's earnings and profits for the current year. A CFC's income from U.S. sources is separately included in the water's-edge tax return.

Generally, California conforms to the federal rules for U.S.-source income, but does not conform to the federal subpart F rules.

"Where" the taxpayer is incorporated (i.e., foreign or domestic) generally has a material effect on the California tax liability of the taxpayer under the water's-edge method of reporting. This is because a domestic corporation includes its domestic and foreign income in the calculation of tax, whereas a foreign incorporated entity would only include its income from U.S. sources in the calculation of tax.

PROGRAM BACKGROUND

A taxpayer filing its California tax return on the worldwide basis will not have its California tax affected by corporate inversions because both domestic and foreign entities are included in the unitary worldwide combined report.

A corporate inversion may reduce a water's-edge taxpayer's California tax liability because the parent corporation is now incorporated in a foreign country. For example:

1. The income received by the U.S. parent corporation from intangible assets, such as patents and trademarks, is fully included in the calculation of California tax. After the inversion, if the U.S. corporation sells the intangible assets to the new foreign parent, only the U.S.-source income from the intangible assets is included in the calculation of California tax.

2. A U.S parent corporation must include a portion of a unitary CFC's income and apportionment factors in the calculation of California tax, if the CFC has subpart F income. After the inversion, if the CFC's stock is transferred to the new foreign parent, the CFC's income is no longer includible in the water's-edge combined report used to calculate the California tax because a U.S. corporation no longer owns the CFC.

Some may think a corporate inversion means jobs and factories are moving abroad, but in fact, nothing real is affected. Commonly, the corporate headquarters for the group remains in the U.S. It is usually a pure paper transaction converting the U.S. parent to a foreign parent. Typically, an inversion is done by shareholders of the original U.S. parent contributing their shares to the new foreign corporation in exchange for stock in the new corporation in equal value. The U.S. corporation is now a subsidiary of the foreign parent corporation, and the operations of the company are usually unchanged. A company will most likely only plan a corporate inversion to create an overall tax savings, the majority of which is federal tax savings.

See Attachment I for an illustration of the effects of a corporate inversion on federal and California tax.

THIS BILL

The provisions added by the bill, once fully implemented, would be similar to federal law and reduce the impact of corporate inversions on the California tax liability of water's-edge electors. The bill provides that former U.S.-based corporations and partnerships that convert themselves to foreign-based corporations will remain subject to California tax as if the corporate inversion never took place. That is, the foreign-based corporation would be taxed as if it were still based in the U.S.

The bill defines an "inverted domestic corporation" as a foreign incorporated entity that, directly or indirectly, acquires the property of a domestic corporation or specified partnerships, if:

1. immediately after the acquisition:
    - more than 50% of the stock is held by former shareholders (or partners) of the domestic corporation (or partnership), or
    - more than 50% of the stock is held by domestic shareholders; and
2. it meets an asset test.

Under the asset test, the assets of the domestic corporation or partnership must be at least 80% of the assets of the resulting foreign incorporated entity. That test would ensure that foreign corporations with other substantial assets are not adversely affected.

This bill would also authorize the Franchise Tax Board to prescribe legislative regulations to treat warrants, options, contracts to acquire stock, convertible debt instruments, and other similar interests as stock and to treat certain stock as not being stock.

IMPLEMENTATION CONSIDERATIONS

The definition of "inverted domestic corporation" contains new, untested rules that are very complex and may need further development. The department will work with the author to address this concern as the bill moves through the legislative process.

TECHNICAL CONSIDERATIONS

The language describing when the provisions of this bill would apply to water's-edge elections made prior to January 1, 2006, may be confusing for taxpayers and the department. The author may wish to revise the language. See attached Amendment 1.

LEGISLATIVE HISTORY

AB 441 (Chu, 2005/2006), AB 2584 (Chu and Levine, 2003/2004), and AB 2109 (Chu 2003/2004) were essentially the same as this bill. AB 441 died on Assembly inactive file, AB 2584 did not pass the first house, and AB 2109 died on Assembly inactive file.

SB 640 (Burton, Stats. 2003, Ch. 657) prohibited the state from entering into any contract with a publicly traded foreign incorporated entity or its subsidiary if that business meets certain conditions that would make it an expatriate company (a domestic corporation or partnership that incorporated in a foreign jurisdiction in name only).

SB 1061 (Senate Rev & Tax Committee, Stats. 2003, Ch. 633), a Franchise Tax Board sponsored bill, fundamentally reformed the water's-edge election procedures to resolve problems that arose with elections made under the previous contract rules. Under SB 1061, water's-edge elections are now made by statutory election rather than by contract.

SB 1067 (Speier, 2003/2004) would have included the income and apportionment factors from an affiliated "inverted domestic corporation" in the water's-edge combined reporting group for California tax purposes. That bill failed to pass out of the house of origin.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, Montana,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida's tax base excludes the federal subpart F income and income from sources outside of the U.S. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the *Florida* affiliated group's tax base.

Illinois begins its computation of the *Illinois* unitary group's tax base with federal taxable income. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the *Illinois* unitary group's tax base. In addition, *Illinois* excludes from the unitary group any corporation having 80% or more of its total business activity outside of the U.S. (the 80/20 rule).

Massachusetts's taxable income is the same as that defined under the federal tax laws, with some adjustments. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the *Massachusetts* combined group's tax base since a foreign corporation cannot be included in a federal consolidated return.

Michigan would not include the foreign-earned income of an inverted domestic corporation in the calculation of tax.

Minnesota would not include foreign-earned income of an inverted domestic corporation in the calculation of tax.

Montana enacted legislation that, starting in tax year 2004, changes the manner in which it taxes corporations electing to file under the "water's edge" method of income apportionment. That change requires that the corporation's return include the income and apportionment factors for any corporation that is in a unitary relationship with the filing corporation and that also is incorporated in a "tax haven." The "tax havens" are specified in the statute to include Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Turks and Caicos Islands, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, Isle of Man, Jersey, Liberia, Liechtenstein, Luxemburg, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga, U.S. Virgin Islands, and Vanuatu.

The *New York* tax base equals federal taxable income modified for income and deduction items that *New York* treats differently. Thus, the foreign-earned income of an inverted domestic corporation would, after inversion, no longer be included in the *New York* tax base.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue gains.

Estimated Revenue Impact of AB 2829 **As Introduced 2/24/06** (in Millions)		
2006-07	2007-08	2008-09
$10	$12	$18

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Existing, and any new, inverted domestic corporations would determine the revenue impact of the bill. As the initial water's-edge seven-year election period expires for an existing inverted corporation, the taxpayer would be subject to the provisions of the bill. The provisions of the bill would require that, under certain conditions, corporations that invert would be taxed as if it were still based in the U.S.

For a list of known inverted corporations, the initial seven-year water's-edge election period expiration was identified. Beginning with the first taxable year after the expiration, the inverted entity and its income and factors within the water's-edge combined report were included. Some inverted corporations would be included beginning in 2006. In 2006, the tax effects for including inverted entities within the water's-edge combined reports are projected at $13.5 million. Other inverted corporations are added in subsequent years as the initial election period expires. In addition, the tax effects are grown each year by the projected growth rates of corporate profits as forecasted by the Department Of Finance. By 2010, the tax effects for including inverted entities within the water's-edge report are projected at $20 million.

New corporate inversion activity appears to have halted. In fact, one corporation that was well along in the process of inverting reversed its decision and remained in the U.S. Therefore, estimates above assume no new inversion activity during the initial three fiscal years.

Taxable years estimates are converted to fiscal year cash flow estimates as indicated in the table.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2829
As Introduced February 24, 2006

AMENDMENT 1

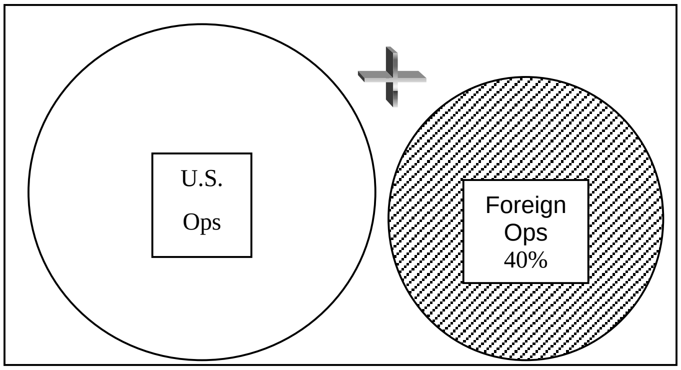
On page 8, strikeout lines 18 to 21, and insert:

in a year prior to January 1, 2006, where that election may not be terminated for that taxable year without the consent of the Franchise Tax Board pursuant to paragraph (9) of subdivision (c) of section 25113 of the Revenue and Taxation Code

ATTACHMENT 1 – DOMESTIC VERSUS FOREIGN TAXATION COMPARISON

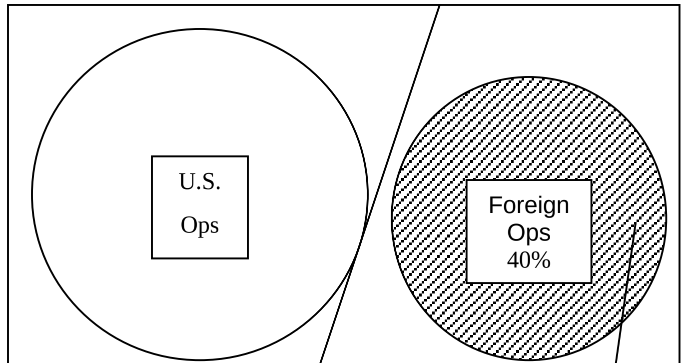
Current Law

U.S. Incorporated Corporation
or U.S. Parent (Domestic)



U.S. Taxes
100% of Net Income
Offset With Foreign Tax Credit

Foreign Incorporated Corporation
or Foreign Parent (Foreign)



U.S. Taxes
Only Net Income From U.S.
Operations
60% of Total Net Income

DOMESTIC REINCORPORATES
OFFSHORE BY CREATING FOREIGN HOLDING COMPANY – IN NAME ONLY – NO SIGNIFICANT CHANGE IN OPERATIONS

<u>Current Federal Impact</u>

Foreign holding company would be treated as a U.S. corporation if certain requirements are met. (IRC 7874)

CALIFORNIA IMPACT

<u>California Impact – Substantial Under Water's-Edge Combined Report</u>

1. 40% of income not taxed and foreign factors not included within water's-edge.
2. Opportunity to convert intangible income from US source to foreign source income.
3. Allows transfer of CFCs to foreign parent, therefore, no CFC income is included for California.

<u>California Impact – None Under Worldwide Combined Report</u>

100% of Income Subject to Apportionment
100% of Factors Included In Formula

AB 441

AB 441 RESULT
Inverted domestic corporation is treated as if it still was a domestic corporation.

100% of Income Inside the Water's Edge
100% of Factors Included Within Water's Edge