Chapter 2 WATER'S-EDGE COMBINED REPORT

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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 you determine 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 apportionment formula is California property, payroll and sales (numerator) over the respective worldwide property, payroll and sales (denominator.) The 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. An entity must:

A. Be unitary. (Revenue and Taxation Code (RTC) §25110(a)(7)(A), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(3), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

B. Meet one of the four tests for 100 percent inclusion, or one of the two tests for partial inclusion. (RTC §25110(a)(1)-(6) and (7)(B), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1) and (a)(2), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

To determine the first criteria, if a unitary business relationship exists, consideration should be given to RTC §25101, and the cases decided by the United States (US) Supreme Court, California courts and the California State Board of Equalization. Pursuant to California Code of Regulations (CCR) §25110(d)(1)(B), a unitary relationship is determined **<u>first</u>** by reference to the relationship that exists between **<u>all affiliated</u>** corporations, not just those entities that have income and apportionment factors required to be considered pursuant to RTC §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 meets any of the tests listed below, it must be included in the water's-edge combined report. An entity that does not meet any of the tests listed below must be excluded, even if the unitary requirement is met. (CCR §25110(d)(1).) Hence, first you determine the members of the worldwide unitary group. Second, you determine of the worldwide unitary group members, which entities meet an inclusion test. These are the members that would make up the composition of the water's-edge group.

2. Water's-Edge Group

RTC §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), described in Internal Revenue Code (IRC) §§921-927, and Domestic International Sales Corporations (DISC), described in IRC §§991-994. (RTC §25110(a)(1), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1)(A), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

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. (RTC §25110(a)(2), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1)(B), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

iii. Corporations incorporated in the US, which are owned and controlled more than 50 percent by the same interests, except for corporations making an election under IRC §936, possession corporations. (RTC §25110(a)(3), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1)(C), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

iv. Export Trade Corporations (ETC), described in IRC §§970-972. (RTC §25110(a)(5), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1)(D), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

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 percentage that their Subpart F income bears to their total earnings and profit (E&P) for the current year. (RTC §25110(a)(6), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(2)(A)(ii), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

ii. A corporation that is not described above is included only to the extent of any US source income and factors. This includes:
   - Corporations not described above
   - Foreign banks, regardless of the bank's average US factors
   - IRC §936 possession corporations with less than 20 percent average US factors

   (RTC §25110(a)(4), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(2)(A)(i), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter. CCR §25110(d)(2)(F)1.)

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 RTC §25105. (RTC §25110(b)(1).) The ownership rules of RTC §25105 contain an over-50 percent "single-entity" standard, except for situations involving family ownership and stapled stock. The ownership requirements of RTC §25105 apply in the same manner for both worldwide and water's-edge taxpayers. (See Multistate Audit Technique Manual - MATM 3050 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 corporation that meets the federal requirements to qualify as a FSC in accordance with IRC §922 or a DISC in accordance with IRC §992, and is unitary, must be included in the water's-edge combined report. A foreign corporation, which has filed a federal election to be treated as a FSC but does not qualify, would be excluded from the water's-edge combined report. (RTC §25110(a)(1), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1)(A), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter. CCR §25110(d)(2)(A).) Thus, FSCs and DISCs are 100 percent included in the water's-edge combined report. (For more information, refer to repealed IRC §§922 and 992.)

2. Repeal of The FSC Rules

In general, Public Law (PL) 106-519, Extraterritorial Income Exclusion Act of 2000, effective for transactions *after* September 30, 2000, repealed the FSC rules. However, the Act provides transition rules for existing FSCs and provides corporations with an exclusion, which is determined on federal Form 8873, Extraterritorial Income Exclusion. (PL 106-519 added IRC §§114, 941, 942 and 943.)

California did not conform to PL 106-519, the Extraterritorial Income Exclusion (EIE) rules. Taxpayers that claim an EIE on their federal tax return should make a California state adjustment to add back to income the federal EIE amount. This adjustment applies to both water's-edge and worldwide taxpayers. Realize, after much debate by the US Senate and Congress, the EIE rules were subsequently repealed as well. The EIE rules were repealed effective for transactions after December 31, 2004. (PL 108-357.)

3. Last Word On FSCs And DISCs

The DISC rules were established in 1971. The FSC rules were established in 1984. Since 1984 the use of DISCs significantly diminished. The FSC rules have been in place since 1984, but were repealed in 2000. Over time, the application of these provisions will be seen infrequently. Regardless, FSCs and DISCs are included 100 percent in the water's-edge combined report.

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. 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. (RTC §25110(a)(5), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1)(D), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter. CCR §25110(d)(2)(E).)

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 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. (RTC §25110(a)(4), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(2)(A)(i), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.) CCR §25110(d)(2)(F).)

Foreign corporations with less than 20 percent US factors and foreign banks must include their US factors and US 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 RTC.

An IRC §936 possession corporation, with less than 20 percent average US factors, would also be included in the water's-edge combined report to the extent of its US source income and US located factors. (RTC §25110(a)(4), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(2)(A)(i), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

A more detailed explanation of the federal US source income and expense rules is discussed in **Chapter 8, Water's-Edge Manual**. See that chapter for more information about deemed subsidiaries.

f. S Corporations

1. In General

An S Corporation can make a water's-edge election. Although an S Corporation cannot have corporate shareholders, the S Corporation rules allow an S Corporation to own corporations. RTC §23801(c) generally precludes S Corporations from inclusion 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 affect 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 on 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. (RTC §23801(d)(1) for tax years beginning before January 1, 2004, and RTC §23801(e)(1) for tax years beginning on or after January 1, 2004.)

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 RTC §25110(a). (If the S Corporation has not made a water's-edge election, then Franchise Tax Board (FTB) can require a worldwide combined report as a means of correcting the transfer pricing issue.)

3. S Corporations With Affiliated FSCs Or CFCs

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

With respect to an S Corporation with an affiliated FSC, a potential IRC §482 issue could exist if the S Corporation reports the same FSC commission expense for both state and federal purposes. For federal purposes, the S Corporation's deduction for commissions paid to the FSC is calculated under repealed IRC §922. California did not conform to IRC §922, and the rules under IRC §922 do not comply with the IRC §482 arm's-length standard. Therefore, the S Corporation must re-determine its commission deduction for California purposes as an IRC §162 ordinary and necessary business expense, applying the IRC §482 arm's-length standard. If there were a CUP, the CUP would be used to determine the arm's-length commission expense that should have been reported by the S Corporation. If no CUP exists, the FSC can be combined with the S Corporation to resolve the transfer pricing issue. For federal purposes, a CFC is required to report on an arm's-length basis with its affiliates, and is also subject to federal IRC §482 examinations.

g. Partnerships, Joint Ventures And Other Hybrid Entities

If a corporation of a water's-edge combined return is a partner, and the partnership's activities are unitary with the corporation's activities, disregarding the 50 percent ownership requirement, then that corporation's share of the partnership's trade or business income or loss is 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 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 Treasury Regulations (TR) §§301.7701-1 through 4 and RTC §23038 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 TR §301.7701-2(b).

2.2 CORPORATIONS WITH TWENTY PERCENT OR MORE UNITED STATES ACTIVITY

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. (RTC §25110(a)(2), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(1)(B), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter. CCR §25110(d)(2)(B)(1).)

This is an annual test, which must be computed separately for each affiliate. While this rule also applies to possession corporations excluded under other water's-edge provisions, it does not apply to foreign incorporated banks. In addition, 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 Section 2.1(f), Water's-Edge Manual, RTC §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, <u>and</u> there must be no exemption from taxation such as that set forth in PL 86-272. (RTC §25110(b)(3).) Commerce between the US and Puerto Rico is considered to be interstate commerce. (See 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. PL 86-272 has no application to foreign commerce. (Foreign commerce means commerce between the US and a foreign country.) As long as the entity engaging in foreign commerce has some minimum level of contact (i.e., nexus) with the destination state, the sales would be considered for purposes of the 20 percent test. 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 there is a geographic breakdown of property and sales in the annual report, consider requesting detail 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 LR 99-1, January 6, 1999.)

Any corporation with 20 percent or more of its average property, payroll and sales in the US is 100 percent included in the combined report.

b. Application Of Treaty Provisions

If the taxpayer files a federal Form 1120F, then a review can be made to see if the foreign corporation is claiming a treaty-based exemption. See the question that states, "Is the corporation taking a position on this return that a U.S. tax treaty overrules or modifies an Internal Revenue law of the United States thereby causing a reduction of tax?" It further states, "If 'Yes,' complete and attach Form 8833." (This is Question W of the 2003 and 2004 federal Forms 1120F, and Question U on the 2005 federal Form 1120F.) If applicable, a separate Form 8833 is required for each treaty-based return position taken. Both this question 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 provides an indication that the foreign corporation may have a presence in the US. It may have property, payroll or sales in the US.

c. Free Or Foreign Trade Zones

It should be determined if a corporation is operating in any Free Trade Zones, also called 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 under the IRC. However, it may be exempt by treaty. (See Revenue Ruling (RR) 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 of the taxpayer's apportionment formula for that state. Note that 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

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. The determination of whether the corporation is taxable in a state is based on the constitution and laws of the US. (RTC §25110(b)(3).) Factors are assigned to a state as long as the state has jurisdiction to tax regardless of whether the state, in fact, taxes the corporation. 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; RTC §25128.)

2. For any state that does not impose a tax on, or according to income, <u>or</u> that does not assign income utilizing an apportionment formula consisting of property, payroll and sales, then the corporation must compute the property, payroll and sales of that state utilizing the California apportionment rules for the factor not utilized 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. 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. In addition, no item of property, payroll or sales shall be assigned in total to more than one state. (CCR §§25110(d)(2)(B)3.d and e.)

    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.) If these sales are made to an affiliate in the water's-edge combined report group they would be eliminated from the computation.

5. 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. *Finnigan* or *Joyce* are applied to determine whether or not to assign the activity or factor to the "non-taxpayer.") On a separate company basis, the entity does not have a factor in the state if its activities are immune from taxation because it does not have nexus in that state.

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; then totaled 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 then summed, 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 <u>each</u> 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

If a possession corporation (US corporation that has made an IRC §936 election) meets the test of having 20 percent or greater activity in the US, then it must be included in the water's-edge combined report notwithstanding its specific exclusion under the "US corporations owned greater than 50 percent" test (or the pre-January 1, 1996 test for "eligibility for inclusion in a consolidated federal Form 1120.") An entity is included to the extent it satisfies any one of the inclusion tests. (CCR §25110(d)(1).)

Although Puerto Rico is not one of the 50 states, as a US possession, it has a unique status that causes 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 of tangible personal property before its sales from Puerto Rico into the US may be considered US sales for purposes of the 20 percent test.

When determining whether a possession corporation has 20 percent or greater activity in the US, intercompany sales to affiliates already included in the water's-edge group must be excluded from the computation.

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. What are Acme PR's sales factor in the US?

Answer: 100%. Computed as follows:

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

For California water's-edge combined reporting purposes, any CFC, defined in IRC §957, with Subpart F income as defined in IRC §952, is partially included in the water's-edge combined report. (RTC §25110(a)(6), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(2)(A)(ii), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.) The inclusion of a CFC's income and factors depends upon the ratio of the CFC's Subpart F income to its current taxable 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. TR §1.951-1(g)(1) defines the term "US shareholder." Note that the 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 also 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 <u>or</u> the total value of the corporate stock. In addition, the over-50 percent ownership must exist for an uninterrupted period of 30 days or more. (TR §1.951-1(a).)

A CFC generally cannot be partially included in a combined report with an S Corporation because of the provisions of RTC §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, the effect of Subpart F is 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, RTC §25110 utilizes some of the definitions and concepts found in Subpart F.

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)
- Foreign Base Company Income (FBCI) (IRC §954)
- IRC 901(j) Foreign Country Income (IRC §952(a)(5))

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

- Pro rata share of Subpart F income
- Investment of Earnings in US Property (IRC §956)
- Other Miscellaneous Items (IRC §951)

For California purposes, the definition of Subpart F income does not include income defined in IRC §956, Investment of Earnings in US Property, or the income defined by IRC §951. (CCR §25110(d)(2)(E)1.)

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 TR.

c. Foreign Base Company Income

IRC §954(a) defines the various types of FBCI. Again, it is the most common type of Subpart F income. FBCI is somewhat different from the other Subpart F income categories because additional requirements must be satisfied before FBCI can be classified as Subpart F income.

There are five categories of FBCI:

- 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 Shipping Income (IRC §954(f))
- Foreign Base Company Oil Related Income (IRC §954(g))
- Income Derived From The Active Conduct of Banking, Financing or Similar Businesses (IRC §954(h))

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 TR for a complete discussion of the applicable exceptions that apply within each category of FBCI.

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. These special rules include:

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

California incorporates these special rules 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.

1. 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. TR §1.954-1T(b)(1)(i) clarifies that the insurance income would remain classified as insurance income. All other remaining gross income would be classified as FBCI.

2. 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.

3. High Foreign Tax Rule

A. 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. The following are considered separate "items of income" for purposes of calculating:

- Foreign Base Company Sales Income
- Foreign Base Company Service Income
- Foreign Base Company Shipping Income
- Foreign Base Company Oil Related Income
- Full Inclusion Foreign Base Company Income
- Foreign Personal Holding Company Income

Foreign Personal Holding Company Income is further broken down into the following categories:

- Dividends, interest, rents, royalties and annuities
- Gains from certain property transactions
- Gains from commodities transactions
- Foreign currency gains over losses
- Income equivalent to interest

The above income items must be further broken down into the separate categories of income, which are referred to as “baskets,” listed under IRC §904(d). For example, if a CFC received a dividend that qualifies as a 10/50 dividend under IRC §904(d)(1)(E), it will also be considered a separate “item of income.”

B. California High Foreign Tax Election

A water's-edge taxpayer can 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. 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. (RTC §25110(a)(6). RTC §25110(a)(2)(A)(ii), for water's-edge elections for years beginning on or after

January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.)

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.

The question then becomes…If a taxpayer does not make the election for federal purposes, is a separate election available for California? 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)(3)(E)3 specifies that IRC §954(b) shall apply 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.

RTC §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 TR issued by "the secretary" shall be deemed to be a proper election for purposes of this part, unless otherwise expressly provided in this part of 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 shall be filed with the FTB at the time and in the manner that may be required by the FTB.

The RTC contains many provisions that do not allow separate treatment for federal and state purposes. For example, see RTC §§23038 (check-the-box), 23604 (enhanced oil recovery credit) and 23610.5 (low income housing credit.) Nothing in the above quoted statute or regulation provides that a taxpayer is bound by its federal election, or lack thereof, for state purposes.

Therefore, a separate election is available; a water's-edge taxpayer can elect a California Subpart F high foreign tax election even if they did not do so for federal purposes.

C. Subpart F 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.

RTC §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 RTC conforms to the IRC or TR, 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.

RTC §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 RTC §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.

It should also be noted that for federal purposes, the high foreign tax rule is provided to exclude income which meets the definition of Subpart F income, but which is not earned in a tax haven jurisdiction. While RTC §25110(a)(6), water's-edge elections for years beginning before January 1, 2006, RTC §25110(a)(2)(A)(ii), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter, does not incorporate the federal method of dealing with deferred tax haven income, does have the same purpose of currently including tax haven entities. This purpose would be undermined by defining a "high tax" jurisdiction as one that imposes a rate of tax greater than 90 percent of the California rate.

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.

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.

d. Water's-Edge Application

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. (RTC §25110(a)(6), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(2)(A)(ii), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.) 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. 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 eliminated as a state adjustment, just as they would be for a worldwide combined report.

Differences may exist between the Subpart F income reported for federal purposes and the Subpart F income used for inclusion ratio purposes. For example:

1. The Subpart F income, deemed dividend, reported by the US shareholder for federal purposes is based on the US shareholder's pro-rata distribution. (IRC §951(a).) For California CFC inclusion ratio purposes, 100 percent of the Subpart F income is included in the numerator. (RTC §25110(a)(6), water's-edge elections for years beginning before January 1, 2006. RTC §25110(a)(2)(A)(ii), for water's-edge elections for years beginning on or after January 1, 2006, and for taxpayers whose elections have already run for 84 months or more on January 1, 2006, or thereafter.) Thus, if the US shareholder owns less 100 percent of the CFC, the reportable Subpart F income for federal and state purposes would be different.

   Example: US Corporation A owns 80 percent of Foreign Corporation B. Foreign Corporation B earned $100,000 of Subpart F income. What is US Corporation A's pro-rata distribution?

   Answer: For federal purposes, $80,000. The $100,000 of Subpart F income is reduced to reflect US Corporation A's pro-rata ownership percentage (80 percent.) For California purposes, 100 percent of the

Subpart F income is included in the inclusion ratio. Therefore, $100,000 would be included in the numerator of the inclusion ratio.

2. Subpart F income for federal purposes may include amounts that were recharacterized in the current year from 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.

3. 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 E&P, which can result in reduced Subpart F income (since Subpart F income for federal purposes is limited to 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.

4. The Subpart F income for federal purposes may include amounts determined under IRC §§951(a)(1)(A)(ii), (iii) or 956. Such items are not included in California CFC 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.

e. CFC 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

The CCR discuss 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 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:

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

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 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 negative California adjusted net income, 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.

For an explanation of how to determine E&P, please refer to **Chapter 11, Water's-Edge Manual.**

f. 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. However, the dividend income of the higher-tier CFC would not be included as Subpart F income to the US shareholder if the dividend was not paid out of previously taxed E&P of the lower-tier CFC. In other words, the dividend income qualifies as FPHCI to the higher-tier CFC when it is received and is included as Subpart F income to the US shareholder assuming the dividend was not paid out of previously taxed E&P. 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 or not 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, what must Calc USA report?

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 TR §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. The distributed dividend is excluded from the calculation of Subpart F income for California numerator inclusion purposes. Based on *Fujitsu IT Holdings*, IRC §959(b) also applies for California purposes.

The denominator of the California CFC inclusion ratio, the current year E&P, should include this dividend income as well. For federal purposes, the current year E&P calculated under IRC §964 will include the previously taxed dividend. Under RR 86-33, dividends paid out of previously taxed E&P are included in the E&P of the higher-tier CFC. If the dividend income was included in the higher-tier CFC's E&P as required for federal purposes, then an adjustment will not be necessary to the denominator of the CFC inclusion ratio.

If the lower-tier CFC has income that qualifies as Subpart F income, then the CFC is included in the water's-edge combined report based on its inclusion ratio. If the higher-tier CFC receives a dividend from the lower-tier CFC, then the same Subpart F income analysis is needed to determine whether or not the higher-tier CFC has Subpart F income. Because dividends generally qualify as FPHCI, the higher-tier CFC will typically have Subpart F income, and will be included in the water's-edge combined report based on its inclusion ratio.

Thus, both CFCs may be included. However, if this occurs and both CFCs are included in the water's-edge combined report, then a determination must be made as to what extent any actual distributed dividend qualifies for elimination pursuant to RTC §25106. (Elimination of a dividend pursuant to RTC §25106 does not affect its treatment as Subpart F income. The Subpart F rules are applied on a separate company-by-company basis.) Refer to CCR §24411(e)(4) for examples of the application of RTC §25106 to CFCs. Also, for more information on the foreign dividend deduction refer to Chapter 13, Water's-Edge Manual.

Example:

Calc USA owns 100 percent of Calc AG, a Swiss CFC holding company. Calc AG owns 100 percent of Type Ltd., an Ireland corporation primarily engaged in manufacturing. The lower-tier CFC, Type, pays a dividend of $5 million to the higher-tier CFC, Calc AG. Type has Subpart F income of $10 million and current E&P of $100 million, which results in a 10 percent inclusion ratio. The high-tier CFC, Calc AG, pays a dividend of $10 million to Calc USA. Calc AG has Subpart F income of $20 million from interest income it received during the year and it has current E&P of $100 million. Calc USA, Calc AG and Type have always filed on a unitary combined basis. What happens as a result of both Calc AG and Type having Subpart F income and both distributing income?

Discussion and Answer:

For federal purposes:

Type has Subpart F income of $10 million, which is a deemed dividend to Calc USA. Calc AG has Subpart F income of $25 million. However, of this $25 million, $5 million is from a dividend paid by Type, 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), Calc USA only has to report $20 million as Subpart F income. Calc USA received a dividend of $10 million from Calc AG. Because this dividend is considered paid out of previously taxed E&P, the dividend is not included in Calc USA's income pursuant to IRC §959(a).

For California purposes:

Based on the ratio of Subpart F income over the current year E&P, Type is included in the water's-edge combined report 10 percent ($10,000,000 / $100,000,000 = 10%) and Calc AG is included 20 percent ($20,000,000 / $100,000,000 = 20%.) Calc AG's Subpart F income for inclusion ratio purposes does not include the $5 million dividend paid by Type. For California purposes, the dividend paid by Type is not considered paid out of previously taxed E&P. Of the $5 million dividend Calc AG received, $1,000,000 ($5,000,000 x 20% = $1,000,000) is included in the water's-edge combined report. Because both Type and Calc AG are partially included CFCs, a portion of the $1,000,000 dividend will be eliminated under RTC §25106. Of the $1,000,000 dividend included in the combined report by Calc AG, $100,000 of the dividend is intercompany eliminated under RTC §25106 (assuming the dividend was paid out of current E&P.) The intercompany portion was calculated by multiplying the $1,000,000 x 10 percent, which is Type's inclusion ratio. The balance of the dividend $900,000 ($1,000,000 - $100,000 = $900,000) is a qualifying dividend, which will qualify for the RTC §24411 deduction.

Of the $10 million dividend Calc USA received from Calc AG, $2,000,000 ($10,000,000 x 20% = $2,000,000) is intercompany eliminated pursuant to RTC §25106, because Calc AG is 20 percent included in the water's-edge combined report. The remaining 80 percent of the dividend remains in the water's-edge combined report and will qualify for the foreign dividend deduction pursuant to RTC §24411. The elimination of an intercompany dividend or the fact that a dividend qualifies for the foreign dividend deduction does not change the CFCs' inclusion rates of 10 percent and 20 percent.

Note that in the example above, Calc AG 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.

g. CFC With US Source Income

Senate Bill (SB) 663, chaptered in May 2006, amended RTC §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.

h. California CFC Considerations

In some cases, a taxpayer may have hundreds of CFCs. In that situation, an efficient way to approach the case may be to identify the CFCs that are most likely to have a material Subpart F issue, and focus the examination on only those entities. For example, a list of all CFCs that can be identified from the California return, the federal Form 1120, the federal Forms 5471 and the taxpayer's Annual Report should be made.

A CFC may be eliminated for reasons such as, it is:

1. Owned less than 50 percent by the water's-edge group. Thus, unity of ownership does not exist. The CFC would not be included in the water's-edge group.

2. Being examined by the IRS, evidenced by the IRS International Examiner's Information Document Requests (IDRs).

3. Inactive or has minimal activity.

4. Manufacturing (refer to comment #3 below.)

5. Operating in a high foreign tax jurisdiction.

For any remaining CFC, a profit and loss statement for each CFC could be requested, and its sources of income can be identified.

Additional considerations:

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 minimus 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 would be 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, RTC §§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

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 asking for 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. Is ownership/control greater than 50 percent?
   b. Is the venture 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. FSCs And DISCs

1. Obtain and review federal Forms 1120 FSC.
   a. What is its ownership structure?
   b. Review the return to ensure that all FSC income has been included in the combined report.

2. Review the consolidated federal Form 1120 Schedule M-1 and reconcile it to the Annual Report or Financial Statements.

3. Does a DISC exist?

d. Export Trade Corporations

1. Review federal Forms 5471.
   a. When was it organized and qualified as an ETC?
   b. What type of trade or business is the CFC engaged in?

2. Review Financial Statements for the three prior years, the current year and subsequent years.
   a. What types of income are being generated?
   b. What are the sources of income and related expenses?

3. Review transactions with the parent company and affiliates.

e. CFCs With Subpart F Income

1. Review the federal Forms 5471.
   a. Where is the CFC incorporated?
   b. In what type of trade or business is the CFC engaged?

2. Review Financial Statements of the CFC.

3. Secure the CFC's tax package.
   a. What type of income did the CFC earn?
   b. What type of expenses did the CFC incur?
   c. How did 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 affects on the Subpart F income.

10. Analyze the activity of a CFC with large apportionment factors and minimal income. Does the CFC meet the de minimis rule?

f. US Source Income

1. Review the federal Forms 1120F.
   a. What is the status of the foreign corporation?
   b. What is its trade or business?
   c. What countries are encompassed in its trade or business?
   d. Does it have an office or fixed place of business in the US? If so, where?
   e. What types of income are reported or reportable?
   f. Is US source income reported?
   g. Is effectively connected income (ECI) reported on the federal Form 1120F, Schedule II?
   h. Review the items deemed non-effectively connected, reported on federal Form 1120F, Schedule 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. Has the foreign entity sold US real property? (Federal Form 8288, US Withholding for Dispositions by Foreign Persons of US Real Property Interests.)

6. Did the foreign entity have 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."

g. US Activity Test

1. Review the federal Forms 1120F or 1120.
   a. What is the entity's trade or business?
   b. Does it have an office or place of business? If so, where?
   c. Is the taxpayer 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 breakdown 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.