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Ms. Colleen Berwick
Franchise Tax Board
Legal Department
P.O. Box 1720
Rancho Cordova, CA 95741-1720

February 8, 2005

Re: Draft Proposed Amendments to Reg. Sec. 25110(d)(2)(F)3

Dear Ms. Berwick:

In FTB Notice 2004-8, December 1, 2004 ("Notice"), the Franchise Tax Board ("FTB") announced that it had prepared a discussion draft of proposed amendments to the existing regulations adopted under California Revenue and Taxation Code ("CRTC") Section 25110. The Notice indicated that if significant public interest was voiced and /or written comments was received by December 31, 2004, the FTB would hold a public meeting or symposium on these proposed amendments prior to the commencement of the formal regulatory hearing process. On December 29, 2004, we previously submitted a letter requesting that the symposium noted in the Notice be held. We submit the following comments regarding the FTB's proposed amendments. As will be explained below, the staff, through this proposal, has an opportunity to correct an error that was committed when the 1992 amendments to Reg. Sec. 25110(d)(2)(F) were first adopted. Alternatively, should the staff of the FTB insist on proceeding with the proposed amendments as drafted, additional guidance must be provided.

THE STAFF, THROUGH THIS PROPOSAL, HAS THE OPPORTUNITY TO CORRECT AN ERROR THAT OCCURRED WHEN THE 1992 AMENDMENTS TO REG. SEC. 25110(d)(2)(F) WERE FIRST ADOPTED.

California's water's edge provisions (CRTC Sec. 25110 through Sec. 25115) were first adopted in 1986, effective for years beginning in 1988. While foreign incorporated entities are generally excluded from the Water's edge group, CRTC Section 25110 delineates foreign entities which have certain characteristics that are includible, in whole or in part, in a California Water's Edge combined report. For



example, under CRTC Section 25110(a)(4), a foreign corporation with less than 20 percent average U.S. factors, or a foreign bank, is includible in a water's edge combined report to the extent of its U.S. source income and factors.

Specifically, CRTC 25110(a)(4) provides:

A corporation that is not described in paragraphs (1) to (3) [DISC; FSC; corporation with 20% or more of its factors in the U.S.; or a corporation incorporated in the U.S. (other than a Sec. 936 corporations) more than 50% of the voting stock owned or controlled by the same interests], inclusive, or paragraph (5) [Export trade corporation], but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the corporation **with respect to its activities conducted within the United States.** (Emphasis added.)

When the FTB first promulgated regulations in 1989 to provide guidance, the FTB defined United States income to mean the income that is effectively connected with a U.S. trade or business ("ECI") under the provisions of the Internal Revenue Code. This was consistent with the highlighted language above, in that ECI is generally associated with activities conducted within the U.S. California Code of Regulations, title 18 ("CCR") Section 25110(d)(2)(F)3, also stated that deductions attributable to U.S. income shall be determined by the allocation and apportionment rules set forth in Treas. Reg. Sections 1.861-8 (other than interest expense) and 1.882-5 (interest expense). Significantly, the latter provision pertains to the allocation of interest deductions in determining ECI for federal income tax purposes and therefore this reference correlated with the underlying income subject to inclusion in a manner consistent with the highlighted language contained in the statute.

Although the underlying statute was never amended, the FTB nevertheless, effective for taxable years beginning on or after January 1, 1992, expanded the scope of U.S. income to include not only ECI but also U.S. source business income that is not effectively connected income ("NECI"). However, the provisions which described how expenses would be allocated were not amended to correspond with this expansion, creating technical confusion, for example, as to how interest expenses should be allocated to NECI. As noted in the Explanation of the Discussion Draft, the FTB's recently proposed addition to the regulation is designed to address this problem by setting forth the manner in which deductions should be allocated to NECI.

Before addressing the issue of how deductions should be attributed to NECI, the more important question is whether NECI should be included in the water's edge combined report in the first place. Clearly, if NECI of a foreign corporation is not properly included in the water's edge combined report, then the question of how deductions with respect to NECI are determined is irrelevant.



The FTB may prescribe rules and regulations necessary for the enforcement of the income tax laws. CRTC Sec. 19503. However, regulations must be in harmony with and not in conflict with existing statutes. The FTB does not have the authority to issue a rule or regulation that alters or enlarges the terms of a legislative enactment. See *Whitcomb Hotel, Inc. v. California Employment Commission*, 24 Cal. 2d 753,757 (1944); *County of Los Angeles v. State Department of Health*, 158 Cal. App. 2d 425, 438 (1958). The validity of a regulation depends upon whether the regulation is consistent with the governing statute. See, e.g., *Ontario Community Foundation, Inc. v. State Board of Equalization*, 35 Cal. 3d 811, 816 (1984); *Appeal of Standard Oil Co. of California*, Cal. St. Bd. Of Equal., Mar. 2, 1983, CCH Calif. Tax Rptr. ¶ 400-383. The 1992 amendments clearly exceed the underlying statute. The staff must take this opportunity to correct this error.

By proposing that NECI of a foreign corporation be included in the water's edge combined report, the staff, first back in 1992, and again today, ignores the highlighted portion of CRTC 25110(a)(4). The second sentence in paragraph (4) of subsection (a) establishes certain requirements that must be met before the income of a foreign corporation can be considered U.S. source income and included in the water's edge combined report. First, the income in question must be considered under federal income tax laws derived from or attributable to sources within the U.S. Second, such income must be determined from the books of account maintained by the corporation. Finally, assuming the income in question meets the first two requirements, it nevertheless must satisfy the last requirement before the income of the foreign corporation can be included in the water's edge combined report. This last requirement provides that the income in question must be derived from "activities conducted within the U.S." This latter requirement is a further limitation of what otherwise might be considered under federal income tax laws as income derived from or attributable to sources within the U.S.

However, the same cannot be said for NECI. The following example illustrates this point:

A foreign corporation (not a bank) lends money to an affiliate in the U.S. All of the lending activities of the foreign corporation take place outside the U.S.

While for federal income taxes purposes, the interest income earned by the foreign corporation may be considered U.S. source income, it does so based upon the nationality of the borrower, not based upon the location of any activities that may have been conducted in the U.S. by the lender. For California purposes, however, CRTC Sec. 25110(a)(4) adds the further limitation that the income must be derived from activities conducted within the U.S. Since none of the foreign corporation's lending activities in this example occurred in the U.S., none of the interest income would constitute U.S. source income to be included in the water's edge combined report notwithstanding the federal conclusion. However, the 1992 amendments to CCR Sec. 25110(d)(2)(F) do not allow for this exclusion. CCR. Sec. 25110(d)(2)(F)1. only excludes NECI that is considered nonbusiness income under CRTC Sec. 25120 and the regulations thereunder. All NECI that is considered business income would be includible per this amendment. However, as the example above illustrates, none of the foreign corporation's activities with respect to this income occurred in the U.S. Thus, pursuant to CRTC Sec. 25110(a)(4), the interest income cannot and should not be included in the water's edge combined report.



ASSUMING THAT THE STAFF CHOOSES NOT TO ADOPT OUR SUGGESTION TO USE THIS OPPORTUNITY TO CORRECT ITS PRIOR ERROR AND INSTEAD PROCEEDS WITH THIS PROPOSAL AS ORIGINALLY DRAFTED, ADDITIONAL GUIDANCE IS NEEDED.

The staff proposes to determine deductions attributable to U.S. income for NECI by reference to another regulation, CCR Section 25120(d). This latter regulation deals with the proration of deductions between business and nonbusiness income. Pursuant to this regulation, deductions are to be prorated in a manner that fairly distributes the deduction amongst various classes of income. Unfortunately, the reference in this proposal to this other regulation does not provide taxpayers with any more guidance than it had before this proposal, since CCR Section 25120(d) is short on specifics as to how this proration is to be determined. Which deductions would be subject to this proration? How is the proration to be computed? Will the proration be done on a company-by-company basis or group basis? These and other questions must be answered. At a minimum, staff needs to provide examples that illustrate exactly how the proration of deductions will be done.

Very truly yours

A handwritten signature in cursive script that reads "Barry Weissman".

Barry Weissman
Director
Tax

cc: Mr. Douglas Anderson, PricewaterhouseCoopers LLP, Sacramento
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