BASIC ISSUES FOR FOREIGN CORPORATIONS DOING BUSINESS IN CALIFORNIA (INCLUDING CALIFORNIA TAXATION) AND REPORTING AND DISCLOSURE REQUIREMENTS OF FOREIGN INVESTORS

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The following is a brief explanation of legal and tax issues relating to foreign investments in California and the U.S., and addresses two main topics. The first topic pertains to California franchise and income tax consequences for doing business in California (see Doing Business in California, below). The second topic addresses the type of governmental or public reporting and disclosure requirements a nonresident individual or company has for their business activities in California (see Foreign Investor Reporting and Disclosure Requirements).

DOING BUSINESS IN CALIFORNIA

California imposes two taxes on corporations that conduct business in California or derive income from sources within California: the franchise tax and the income tax. These two taxes are discussed below. Additionally, a foreign corporation (a corporation, association or other legal entity that is not incorporated in California) that conducts intrastate business in California must obtain a Certificate of Qualification to do business in California.

Any corporation, whether it is a Delaware, Swedish, Texas, or Mexican corporation that "does business" or "derives income from sources within California" is generally subject to California's tax laws.[a]

Thus, **foreign** corporations that are either (i) "doing business" within California, or (ii) deriving income from sources within California, are subject to California's tax laws. Furthermore, if a foreign corporation derives income from both within and without California (e.g., California, Texas, and Mexico), an allocation of income between the states is necessary to calculate the exact amount of the California tax.

CALIFORNIA FRANCHISE TAXES

California imposes upon all corporations "doing business" within California an indirect tax for the privilege of exercising their corporate franchises in California. This tax is known as the franchise tax, and is measured by the income of the corporation for the preceding year (and thus the franchise tax is "indirect" income tax). If a corporation is doing business in California, then it is subject to the Corporation Franchise Tax and not the Corporation Income Tax.[b]

"Doing business" within California is defined as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.[c] A corporation generally will be doing business in California (and thus subject to the franchise tax) by entering into various contracts in California, hiring California employees and performing other substantive business activities in California.

If a corporation doing business in California has no taxable income (or even has a loss), there is a minimum franchise tax of $800 per year.[d] This minimum franchise tax of $800 applies to any corporation, including California corporations, and is an inescapable cost of doing business in the corporate form in California. Additionally, if the foreign corporation that does business in California earns net income from within California from those business activities, that net income[e] is the basis for imposing a 8.84 percent tax, commonly known as the "privilege tax."[f]

CALIFORNIA CORPORATION INCOME TAX

Separate from the franchise tax, California's Corporation Income Tax reaches those corporations which are not subject to the franchise tax (i.e., not "doing business" in California), but which derive income from California sources. The corporation income tax is imposed upon net income derived from sources within California.[g] This tax is imposed at an 8.84 percent rate on the corporation's "net income" derived from California sources. Net income is computed by taking the corporations' gross income and reducing it by any allowable deductions. Both the franchise tax rate (excluding the minimum franchise fee of $800.00) and the corporation income tax rate are both 8.84 percent measured against net income.

CALIFORNIA'S WORLDWIDE TAX SYSTEM (UNITARY TAX)

Foreign corporations should be aware of California's worldwide combined reporting method of taxation. In contrast to the arm's-length, separate accounting method employed by the U.S. federal government, California's system calculates a business enterprise's income taxes by treating as a single enterprise all of the worldwide affiliates of a multinational business group that are engaged in a so-called "unitary" business. Once the worldwide income is determined, it is divided between California and the rest of the world on the basis of a three-factor apportionment formula of property, payroll, and sales.

This method of taxation employed by California has been extremely controversial. California consequently amended its worldwide taxing system by modifying the requirement that taxpayers file income tax returns on a worldwide combined basis. California enacted legislation effective on January 1, 1988, which permits a corporate taxpayer engaged in a worldwide unitary business to elect to compute its California franchise tax liability on the basis of its U.S., as opposed to its worldwide business operations.[h]

The term "water's edge" refers to this method of taxation which taxes U.S. corporations as a unitary business, but only on the income earned between the "water's edges." Thus, after a water's edge election is made, the foreign affiliated corporations (e.g., a Canadian or Mexican corporation) are not normally subject to California's unitary corporate income tax reporting and compliance system. The U.S. corporation must include other U.S. subsidiaries in its unitary business if that domestic corporation can be included in a U.S. federal consolidated tax return. Also, certain foreign subsidiaries must be included if more than twenty percent of the foreign corporation's average property, payroll, and sales are generated in the United States.

The water's edge provisions were amended in 1993, largely in response to the constitutional challenges brought by Barclays Bank. These amendments modified the "water's edge" election in three principal respects. First, the 1993 law removed the fee that foreign corporations were required to pay if they wished to limit combined reporting of their income to a "water's edge" group. Second, the California Franchise Tax Board usually may not disregard a corporation's water's edge election and the taxpayer corporations cannot generally be forced to file on a worldwide combined basis. Third, the 1993 law no longer requires a Domestic Disclosure Spreadsheet. Instead, large corporations may file a list of 20 percent-or-more owned affiliates.

Even when the water's edge is made, all income earned in the United States must still be apportioned and reported (for California tax purposes) on the basis of the three-factor apportionment formula of property, payroll, and sales in the different states within the United States.

There can be drawbacks of the water's edge election since all of the subsidiaries in the U.S. taxing jurisdiction must also use the water's edge method. Also, before a corporate taxpayer is eligible to use the water's edge method of taxation they must sign a contract with the California Franchise Tax Board ("FTB") with various terms and conditions.

In Summary, California's worldwide combined reporting method can be costly and administratively burdensome, especially if a "water's edge" election is not made.

FOREIGN CORPORATIONS: QUALIFICATION TO DO BUSINESS IN CALIFORNIA

Foreign corporations that do business in California have an additional burden of operating in California, as compared to a California corporation. A foreign corporation (e.g., a Delaware, Texas, Germany or Mexican corporation) is prohibited from transacting "intrastate business" in California without first obtaining a Certificate of Qualification to do business in California from the California Secretary of State.[i] There is a filing fee to a foreign corporation to transact intrastate business in California.

The Certificate of Qualification that must be filed with the Secretary of State, and all of the information contained therein is a matter of public record. The information which must be included in this Certificate includes the following:

- The foreign corporation's name and state of incorporation (including approval by the California Secretary of State of the business name);
- The address of the foreign corporation's principal executive office;
- The address of the foreign corporation's principal office within California, <u>if any</u>;
- The name of an agent for service of process for the foreign corporation, which must generally be updated annually; and
- The foreign corporation's irrevocable consent to service of process upon that designated agent.

Additionally, the foreign corporation must file with the Certificate of Qualification certificate from an authorized public official (e.g., Delaware Secretary of State or Mexican Public Registry of Commerce) that the foreign corporation is a validly existing corporation in good standing in the State of incorporation.

A California corporation does not have to qualify to do business with California's Secretary of State, since by virtue of its incorporation in California it has already been granted its authority to conduct business within California.

In summary, if a corporation's business activities will be conducted in California, a foreign corporation (non-California corporation) will be subject to California's franchise and/or corporate income taxes as well as certain California corporate laws. Any corporation doing business in California will be required to pay annually a minimum franchise tax of $800. A foreign corporation will also have to qualify to do business with the California Secretary of State at an additional cost. Additionally, any non-California corporation (e.g., a Delaware corporation) will still be subject to the costs and requirements imposed upon it by that State's laws. For instance, a Delaware corporation must currently pay an annual franchise tax to Delaware and annually file a franchise tax report with Delaware for the privilege of being able to conduct itself as a Delaware corporation, even if it conducts no business within the State of Delaware.[j]

FOREIGN INVESTOR REPORTING AND DISCLOSURE REQUIREMENTS

The second and last part of this discussion briefly addresses the type and scope of governmental or public disclosure and reporting requirements that a foreign corporation will have for its business activities in California.

Almost all reporting and disclosure requirements which are placed on non-U.S. investors are imposed by the federal government. Although California laws may generally apply to a foreign corporation's activities within the United States, California has no specific reporting or disclosure laws applicable only to foreign investors and foreign companies.

REPORTING BY FOREIGN-OWNED CORPORATIONS TO THE IRS

The U.S. federal tax law obligates "domestic" corporations (corporations which are incorporated in the U.S.; e.g., California or Delaware) which have one or more "25% foreign shareholders" to report the following information to the federal government[k]:

- The name of the corporation;
- The principal place of the corporation's business;
- The nature of the corporation's business;
- The country or countries in which the "25% foreign shareholders" reside or have citizenship; and each foreign shareholder's name and foreign address;
- The country where a "related party" who had transactions with the corporation resides (a "related party" is generally one who is related to the "25% foreign shareholder" or the corporation through common ownership or family relationships), and that person's name and foreign address;
- Any transactions between the corporation and the foreign owner or "related party" (e.g., sales of stock, commissions paid, purchases of stock, interest paid, leases, licenses, etc.); and
- Any other information prescribed by the government through regulations.

These reporting requirements have become increasingly demanding since the law changed in 1990. Indeed, a corporation which fails to comply with these reporting requirements is potentially subject to a $10,000 penalty for each failure to report.

These reporting requirements apply only to U.S. corporations which have a "25% foreign shareholder"; i.e., where one foreign person owns at least 25 percent of the voting stock or value of those shares in the U.S. corporation. Thus, if a nonresident alien individual owns only 24 percent of a California corporation, for example, he or she will not be subject to this reporting requirement. Plus, there are other possible planning techniques which can be used to avoid these reporting requirements.[l]

INTERNATIONAL INVESTMENT SURVEY ACT

The International Investment Survey Act (the "IISA") imposes certain reporting requirements on foreign investors. The purpose of this law is ostensibly to enable the U.S. government to compile detailed information regarding international investment and investment patterns in the U.S. The U.S. government can use the financial information reported under the IISA only for analytical or statistical purposes and is prohibited from using the information for taxation, investigation, or

regulation.

Annual reporting is required of "foreign direct investment in the United States" where a foreign person owns or controls 10 percent or more of the voting securities of certain incorporated U.S. business enterprise.[m] The exact size of the U.S. corporation will determine whether initial and on-going reports are required. Typically annual reports are required (on Form BE-15) of U.S. business enterprises, other than banks, if more than 10 percent of the company is owned by a foreign person. Also, reports between the U.S. company and the foreign person with a direct investment of 10 percent or more, must file certain reports of those transactions (on Forms BE-605 and BE-606B). These reports are submitted to the U.S. Department of Commerce.

In summary, foreign companies that desire to conduct business in the U.S. (and particularly in California) need to be aware of (a) the special worldwide unitary corporate income/franchise tax in California, (b) special reporting requirements to the U.S. Internal Revenue Service, and (c) special reporting requirements to the U.S. Department of Commerce imposed by the International Investment Survey Act.

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[a] *18 Cal. Adm. Code Reg. §§ 23501-23504.*
[b] *18 Cal. Adm. Code Reg. § 23501-23504.*
[c] *Cal. Rev. & Tax. Code § 23101.*
[d] *Cal. Rev. & Tax. Code § 23153(d)(1).*
[e] *Net income is generally computed by the following method:*
* *Corporation's Gross Income (from whatever source derived):*
* *Less: Deductions (E.g. trade or business expenses such as cost of goods sold, compensation paid to employees, rent expense, other overhead costs, professional fees, interest expense, property taxes, etc.)*
* *Net Income*

[f] *Cal. Rev. & Tax. Code § 23151(d).*
[g] *Cal. Rev. & Tax. Code § 23501.*
[h] *California Revenue & Taxation Code Section 25110.*
[i] *Cal. Corp. Code § 2105.*
[j] *See Delaware Corp. Code §§ 501, et. seq.*
[k] *I.R.C. § 6038A.*
[l] *I.R.C. § 6038A.*
[m] *15 C.F.R. §§ 806.1-806.18.*