

**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Water's Edge Manual

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**Chapter 3 Water's-Edge Election And Contract**

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### Section 3.1 Water's-Edge Election And Contract - In General

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### ***Training Objectives:***

By the end of this section the reader will be able to:

1. Determine which taxpayers are covered by a water's-edge election.
2. Determine how the election is made, and the term of the contract period.
3. Determine the requirements of a valid water's-edge contract.
4. Be aware of the changes to the water's-edge provisions affecting elections made for income years beginning on or after January 1, 1994.
5. Identify when a deemed water's-edge election exists.

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### **a. Introduction**

The purpose of this chapter is to discuss the requirements for the water's-edge election and contract. The auditor will need to know the requirements in order to determine whether a valid election was made, whether a deemed election exists, and determine the effects of a Notice of Nonrenewal and termination on the water's-edge contract period.

It is important to note that in 1993, legislation (SB 671, Stats 1993, Ch. 881) was enacted which made substantial changes to the water's-edge provisions. The new provisions are effective for income years beginning on or after January 1, 1994. The most important change made by this legislation was to revoke all existing water's-edge contracts entered into for income years beginning prior to January 1, 1994. For new contracts entered into on or after January 1, 1994, the following changes to the water's-edge provisions apply:

- Elimination of the election fee.
- Elimination of the requirement to file Domestic Disclosure Spreadsheets (DDS).
- An eighty-four month contract period rather than a sixty-month contract period.
- Elimination of some conditions under which a taxpayer can terminate a water's-edge election prior to the seven-year period.
- Elimination of provisions that allow the FTB to disregard water's-edge elections for specified reasons.

In 1998, CCR §25111 and §25111-1 were amended to relax the requirements for making a valid water's-edge election. Whereas the department had previously taken the position that strict adherence to procedural and statutory requirements was necessary for a valid election, the regulations now provide that a water's-edge election will be considered valid as long as the taxpayer has "substantially performed" the requirements. These amendments to the regulations apply retroactively to all open years.

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### ***b. Definitions***

To understand the water's-edge contract and election issues, the following definitions are relevant.

#### ***1. Affiliated Bank Or Corporation***<sup>1</sup>

The water's-edge statute describes "affiliated" banks or corporations required to be included in a water's-edge combined report. For income years beginning prior to January 1, 1994, an "affiliated" bank or corporation means a bank or corporation which is related to a bank or corporation required to file under the RTC, because of any of the following:

- A. It directly or indirectly owns more than 50 percent of the voting stock of the bank or corporation that is required to file under the RTC.
- B. More than 50 percent of its voting stock is owned directly or indirectly by a bank or corporation required to file under the RTC.
- C. More than 50 percent of the voting stock of both it and the bank or corporation required to file under the RTC is owned or controlled directly or indirectly by any bank or person (as defined by IRC Section 7701(a)).

This language effectively provided that ownership was met only when the stock of an affiliated bank or corporation was ultimately held by a single individual or entity because of the statute's reference to ownership by "a bank or corporation" or "any bank or person" (i.e., reference was to a single individual or entity). In contrast, for income years beginning before January 1, 1995, RTC Section 25105 did not specifically contain a single-entity ownership standard. (The FTB had historically maintained that such a "single entity" standard was implicit in the language of former Section 25105. The California courts rejected this interpretation in Rainbird Sprinkler Mfg.<sup>2</sup> and Hugo Neu-Proler International Sales Corp.<sup>3</sup> In response to these cases, FTB Issued Legal Ruling 91-1 which held that unity of ownership could be established not only by a single-entity, but also when a group of shareholders, acting in concert, jointly controlled a group of corporations.)

Because of the definition of affiliated group contained in the water's-edge statute, for income years beginning prior to January 1, 1994, Legal Ruling 91-1 did not

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apply to determine the members of the water's-edge group. For such years, the water's-edge statute defined "affiliated" bank or corporation subject to inclusion in the water's-edge group as those entities meeting a more than 50% ownership by a single entity standard. In other words, even though an entity might meet the unity of ownership standard of Section 25105 (as interpreted by Legal Ruling 91-1) it would only be includible in the water's-edge combined report if it met the ownership by a single entity standard set forth in Section 25110(b)(1).

However, for income years beginning on or after January 1, 1994, RTC Section 25110(b)(1) was amended to cross-reference to RTC Section 25105. Therefore, the ownership rules of Section 25105 (including the Legal Ruling 91-1 interpretation of the statute) applies to determine the water's-edge group for income years beginning on or after January 1, 1994. For income years beginning on or after January 1, 1995, the new unity of ownership rules in RTC Section 25105 take effect and apply for both worldwide and water's-edge taxpayers (i.e. Legal Ruling 91-1 does not apply. Instead, new RTC Section 25105 codifies an over 50 percent "single-entity" standard except for situations involving family ownership and stapled stock. See MATM 3050 for more information).

For purposes of the water's-edge provisions for years beginning before January 1, 1995, an affiliated bank or corporation is an entity that is a member of a commonly controlled group of which the taxpayer is also a member. It is not necessary that more than 50 percent of the voting stock of an entity be owned by another entity. It is sufficient if more than 50 percent of the voting stock of an entity is owned by a commonly controlled group of entities. However, ownership is not established through a less-than-50 percent owned entity's ownership of stock of other entities.<sup>4</sup>

Example 1:

Corporation A owns 60% of Corporation B's voting stock and 30% of Corporation C's voting stock. Corporation B owns 30% of Corporation C's voting stock. A, B and C meet the §25105 ownership standard and the water's-edge affiliation standard. (A directly or indirectly owns 60% of C's voting stock).

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### Example 2:

Corporation A owns 40% of Corporation B's voting stock and 30% of Corporation C's voting stock. Corporation B owns 60% of Corporation C's voting stock. A is not affiliated with B and C because it does not directly or indirectly own more than 50% of their voting stock.

(The auditor should remember that the definition of an "affiliated taxpayer" or an affiliated bank or corporation for California water's-edge purposes is not the same as the definition of an "affiliated group" under federal purposes. See IRC Section 1504(a)).

## ***2. Water's-Edge Group***

Chapter 2, Water's-Edge Manual discusses which "affiliated" entities are required to be included in a water's-edge combined report. The water's-edge group means all banks, corporations or other entities whose income and apportionment factors are considered under RTC 25110(a) in computing the income of the individual taxpayer for the current income year which is derived from or attributable to sources within this state.<sup>5</sup>

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### **3. Qualified Taxpayers**

A qualified taxpayer for purposes of the water's-edge election is a corporation which:

1. Files with the state return on which the election is made a consent to:
  - a. the taking of depositions, and
  - b. the acceptance of subpoenas duces tecum.<sup>6</sup> (See Part 2 in Section 3.1(k), Water's-Edge Manual for more information).
  
2. Agrees to business income treatment of dividends from:
  - a. more than 50%-owned foreign subsidiaries that are in the same general line of business, or
  - b. regardless of the 50% ownership requirement, a bank or corporation which is a significant source of supply to or a purchaser from the unitary business. (See Section 3.1(l), Water's-Edge Manual for more information).<sup>7</sup>

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### *c. Taxpayers Covered By The Election*

All affiliated banks or corporations engaged in a single unitary business must file on the same basis. Accordingly, if a water's-edge election is made, all taxpayers in the unitary business must file on a water's-edge basis.

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### ***d. Making The Election***

#### ***1. Election Requirements In General***

In addition to requiring the taxpayer to consent to the taking of depositions and the acceptance of subpoenas duces tecum as a condition to entering into a contract, §25111 requires that the following three conditions be satisfied before the water's-edge election will be considered valid:

- A. The election must be made by contract.
- B. Every taxpayer member of the water's-edge group must make the election.
- C. The election must be made on the original return.

These conditions are discussed in more detail below.

In 1998, Regulation §25111(a)(2) and §25111-1(a)(2) were retroactively amended to provide that a water's-edge election will be considered valid as long as there has been substantial performance of the requirements for entering into the contract. "Substantial performance" means that even though the taxpayer did not comply with all of the statutory or procedural requirements, the tax was computed consistent with a water's-edge election and there is additional "objective evidence" to support the conclusion that an election was intended.<sup>8</sup> Basically, this means that there is evidence which makes it clear that the taxpayer(s) intended to make a water's-edge election for that year. Specific examples of what will be considered to be "objective evidence" and "substantial performance" are discussed below.

If the taxpayer has substantially performed the requirements for entering into a water's-edge election, then the election is considered valid and the taxpayer is bound by the terms of the water's-edge contract.

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### **2. The Contract Requirement**

A water's-edge contract, FTB Form 100-WE, must be attached to the original return. (For 1988 and 1989, the contract form number was FTB Form 1115.)

If the taxpayer did not attach a contract, then the auditor will have to determine whether there has been substantial performance of the contract requirement. Substantial performance will exist if both of the following conditions have been met:

**Condition 1: The tax was computed consistent with a water's-edge election.** In some situations, judgement may be required to determine whether this condition has been met. For example, what if a taxpayer excludes some foreign affiliates but includes others, and the inclusion is not consistent with any of the water's-edge inclusion rules? Or, what if the taxpayer excludes all of its foreign affiliates and disregards water's-edge provisions such as partial inclusion and the foreign dividend deduction, even though those provisions do apply to the taxpayer and are material to the tax computation? It will be necessary in these types of situations to evaluate all of the facts and circumstances to determine whether the taxpayer was attempting to compute the tax consistent with a water's-edge election or whether the filing was based on some other theory.

**Condition 2: There is additional objective evidence to support the conclusion that an election was intended.** Essentially, "objective evidence" will exist if there is evidence to indicate that the taxpayer intended to make a water's-edge election for that year. With a couple of exceptions that are identified in the regulations, the objective evidence should be on the original return for the year of the election. A filing position taken in previous years is not objective evidence that the taxpayer intended to make a new water's-edge election in a subsequent year. Furthermore, because the election must be made on an original return, actions taken by the taxpayer after the original

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return has been filed cannot be considered objective evidence of the taxpayer's intent on the original return.

Regulations §25111(a)(2)(A)(i) and §25111-1(a)(2)(A)(i) indicate that "objective evidence" exists if:

- a. One or more substantially completed water's-edge forms are attached to the original return. This includes the 100-WE, the DDS forms, the fee forms, the Form 1116, 2411, 2416, 2424, 2426, etc.
- b. The taxpayer filed a domestic disclosure spreadsheet before 1/1/97. This applies to pre-1994 years only.
- c. A Form 1117 request to terminate an election was filed before 1/1/97. This will be considered objective evidence if the first year of the intended election can be determined from the termination request.
- d. A statement was attached to the original return indicating that the taxpayer was intending to make a water's-edge election.
- e. Checking a "water's-edge" box on the return *may* be objective evidence of an intent to make an election. However, if other evidence indicates that the taxpayer did not intend to make an election and the box was checked by mistake, a checked box may not be sufficient by itself to constitute "objective evidence."

Objective evidence is not necessarily limited to the items listed above. In order to meet the substantial performance test however, the objective evidence must be sufficient to support the conclusion that a water's-edge election was intended.

### ***3. Every Member Must Elect***

The election is valid only if every taxpayer member of the water's-edge group elects to file on a water's-edge basis. The election can be made by filing a separate contract for each taxpayer or it can be made by filing a contract signed by the common parent corporation.

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If one or more taxpayer members of the water's-edge group are not included in a common parent election and have not filed their own separate contracts, there may still be a valid election if there has been substantial performance of the election requirements. Whether or not there has been substantial performance is determined by reference to the actions of the entire water's-edge group. Therefore, even though a particular taxpayer member of the group may not have substantially performed, there will still be a valid water's-edge election if the group as a whole has substantially performed.

### Example 3:

Corporations A, B, C, and D are U.S. incorporated unitary subsidiaries of a foreign parent. The predominant California activities belong to Corporations A and B. Corporations C and D are relatively minor subsidiaries in terms of income and factors. A, B and C each filed separate 1995 returns and determined their income attributable to California sources on the basis of a combined report that included the income and factors of A, B, C and D. A, B, and C each attached a water's-edge contract to their original return. D filed its return on a worldwide basis. D did not attach a water's-edge contract to its separate return.

Whether or not there is a valid water's-edge election will be depend upon whether the group, taken as a whole, substantially performed the election requirements. The predominant portion of the group clearly intended to make a water's-edge election. Under these facts, there has been substantial performance by the group as a whole. A valid water's-edge election exists for Corporations A, B, C, and D.

### **4. Elections By Common Parent**

A water's-edge election can be made by the common parent of a controlled group which files a consolidated federal return pursuant to IRC Section 1501, or by the ultimate common parent of the water's-edge group regardless of where it is organized or domiciled.<sup>9</sup> The common parent does not have to be a California taxpayer or a member of the water's-edge group. However, if the common parent is not a taxpayer member of the water's-edge group, the common parent election must be made on an original return filed by a taxpayer member of the water's-edge group.

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A common parent election made by the ultimate common parent will constitute an election by all taxpayers in the water's-edge group. A common parent of a federal consolidated group can only elect on behalf of the corporations that it controls. If there are taxpayer members of the water's-edge group that are not included in the federal consolidated group and are not controlled by the parent of the consolidated group (such as a brother/sister corporation), those taxpayers will not be covered by the common parent election.

The common parent election will constitute a water's-edge election for the members of the controlled group regardless of whether one of the members files on a non-water's-edge basis.

A common parent may also file a Notice of Nonrenewal on behalf of the taxpayers in its controlled group. For more information on Notices of Nonrenewal, see Part 2 in Section 3.1(i), Water's-Edge Manual.

### Example 4:

Corporations A (parent) and B (subsidiary) are unitary. A is a calendar year taxpayer. B is a fiscal year taxpayer with June 30 income year-end. A filed its 1994 return on October 15, 1995 and determined its income attributable to California sources on the basis of a combined report that included the income and factors of itself and B. A made a water's-edge election by attaching a contract to its original return. A checked the box on FTB Form 100-WE indicating that it was making the election on behalf of its subsidiary B. Because the corporations have different income year-ends, B must file a separate return for its fiscal year ending June 30, 1995. B filed its separate return on September 15, 1995 and did not attach a water's-edge contract to its return.

The common-parent water's-edge election made by A on October 15, 1995 is a valid election for both A and B notwithstanding the fact that B did not attach a copy of the common parent election to its return. The common-parent water's-edge election made by A would be valid for both A and B even if B had computed the tax on its separate return on a worldwide basis.

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### Example 5:

Corporations C and D are brother/sister corporations with a common foreign parent. Corporation C owns E, a domestic company. C and E filed on a consolidated basis for federal purposes. C, D and E are unitary and filed a single return on a combined basis for California purposes for 1994. C attached a water's-edge contract to the return and checked the box on the contract indicating that it was also making the election on behalf of the affiliates.

C's contract only constituted an election for E, its subsidiary. C cannot make a common parent election for its affiliate D because C is not a common parent corporation for D. To comply with the statutory and procedural requirements for making the election, D should have made a separate election by attaching a contract to the original return. Alternatively, the common foreign parent could have made the election on behalf of all three corporations by checking the appropriate box on the contract (Form 100-WE) and having the taxpayers attach a copy to the California returns. However, because D filed with C and E on a single return that was computed on a water's-edge basis and included water's-edge forms (the Form 100-WE), there has been substantial performance of the election requirements by the group as a whole. ***Therefore, the election will be considered valid.***

If D's tax had not been included on a single return with C and E, and D had instead reported its share of the combined report business income on a separate return, then the determination of whether there has been substantial performance might be more problematic. If D did not substantially perform on its separate return, it will be necessary to look at the overall facts and circumstances of the group to determine whether the group as a whole substantially performed the election requirements.

### ***5. Election Allowed Along Unitary Business Lines***

If a taxpayer or an affiliated group of taxpayers is engaged in more than one unitary business, it may make a water's-edge election with respect to any one or more of its businesses. It need not elect for all of its businesses.<sup>10</sup> Each unitary business filing on a water's-edge basis must file a separate election.

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### Example 6:

Corporation A, a conglomerate, owns three nonunitary corporations and their subsidiaries, Corporations B, C, and D. Corporations B, C and D were engaged in the business of manufacturing aerospace items, growing tobacco products, and producing and distributing motion pictures, respectively. There are three unitary groups: (1) Corporation B, its unitary subsidiaries, and A's aerospace division; (2) Corporation C, its unitary subsidiaries, and A's tobacco products division; and (3) Corporation D, its unitary subsidiaries, and A's motion picture division. Corporation A may make water's-edge elections with respect to the tobacco products business and motion picture business, but may continue worldwide combined reporting for the aerospace business. The fact that Corporation A did not elect to file on a water's-edge basis for the aerospace business does not nullify the elections for its other unitary businesses.

### **6. Election Must Be Made On An Original Return**

To be effective, the election must be entered into by contract at the time the original return for the year is filed.<sup>11</sup> The statute does not require the return to be timely filed so long as it is considered an original return. Once an original return is filed, an amended return cannot be filed to make or perfect an election.

For purposes of §25111, Regulation §25111(e) and §25111-1(e) clarify that the "original return" is the last return filed on or before the due date or extended due date. If no return is filed by the extended due date, then the original return will be the first return filed after that date.

If a timely filed return supplements or corrects errors on a previously filed return, it will be considered as incorporating the previously filed return to the extent that it is not inconsistent with that previously filed return. Therefore, to the extent that a subsequently filed timely return is not inconsistent with a water's-edge election that was made on a previously filed return, the subsequently filed return will be considered to have incorporated the water's-edge election. On the other hand, if a subsequently filed timely return clearly reflects an intent to withdraw a water's-edge election made on a previously filed return, there will not be a valid election.

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### Example 7:

Corporation T, a calendar year taxpayer, files a return on February 15 and files a second return on October 15. Because the first return was filed before the March 15 due date, there was no automatic extension or extended due date. Therefore, the return filed on February 15 is the original return and the October 15 return will be considered an amended return. To be effective, the water's-edge election must have been made on the February 15 return.

### Example 8:

Corporation T, a calendar year taxpayer, files a return on May 15 and files a second return on October 15. Because no return was filed before the original due date, T had an automatic extension until October 15. The return filed on October 15 is the last return filed on or before the extended due date, so it will be considered the original return. T may make a valid water's-edge election on the October 15 return even if no election was made on the May 15 return.

Now assume that T did make an election on the May 15 return. If the October 15 return was not inconsistent with that water's-edge election, then the May 15 election will be incorporated into the October 15 filing even if the taxpayer did not attach a copy of the contract to the October 15 filing. However, if the October 15 filing withdraws the May 15 election, the taxpayer will not be considered to have made a valid election.

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### **e. *New Elections Required In 1994***

In 1993, significant changes were made to the water's-edge provisions, including an automatic rescission of all water's-edge contracts as of December 31, 1993.<sup>12</sup> The new provisions are effective for contracts entered into for income years beginning on or after January 1, 1994.

Although the statute automatically rescinds existing contracts, an exception to the general rule is made for combined groups of taxpayers with different income years. All taxpayers that are members of a water's-edge group consisting of taxpayers with different income years will continue to be bound by the contract in effect as of December 31, 1993, until the income years beginning prior to January 1, 1994, and ending in 1994 for each of the taxpayer members of the water's-edge group has ended.<sup>13</sup>

#### Example 7:

Corporations A and B are California taxpayers engaged in a unitary business. A's income year ends December 31 and B's income year ends March 31. A and B made a water's-edge election effective for the 1991 income year. The election period began April 1, 1991 and ends on March 31, 1996 (assuming a Notice of Nonrenewal was filed).

A's water's-edge contract will be rescinded March 31, 1994. A will continue to be bound by the terms and conditions of the contract in effect as of December 31, 1993, except for the requirement to pay the fee, through March 31, 1994. B will continue to be bound by the contract, including the requirement to pay the fee, through March 31, 1994.

If A and B wish to continue to file on a water's-edge basis for the period beginning April 1, 1994, they must make a new election. The new election will commence April 1, 1994 and would end March 31, 2001 (assuming a Notice of Nonrenewal is filed).

Under the prior law, effective for income years beginning on or after January 1, 1988 and prior to January 1, 1994, the taxpayer making the election agreed to:

1. File returns on a water's-edge basis for 60 months (5 years).

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2. Pay an annual fee under Section 25115.
  3. File a Domestic Disclosure Spreadsheet (DDS) every three years under RTC Section 25401d.
  4. Agree to business income treatment of dividends from more than 50%-owned foreign subsidiaries in the same general line of business or from any foreign subsidiaries which are a significant source of supply or which are significant purchasers.<sup>14</sup>
  5. Consent to certain procedures for obtaining information through depositions and subpoenas,<sup>15</sup> and
  6. Furnish certain information on request at audit.

For a water's-edge election made for income years beginning on or after January 1, 1994, the following changes apply.

1. The requirement to pay an annual fee is eliminated.
2. The requirement to file a DDS is eliminated.
3. The contract period is revised to an 84-month period (7 years).

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### ***f. Locating And Verifying Water's-Edge Contract Information***

#### ***1. How To Locate Water's-Edge Contract Information***

For income years beginning prior to January 1, 1994, water's-edge contract information is maintained on a PC database system that has limited accessibility. For income years beginning on or after January 1, 1994, water's-edge contract information can be viewed on-line through BETS. On BETS, the water's-edge information will be shown on conversation \* \* . This screen will show, in addition to other information, the contract beginning and ending dates, a status code, and an indicator showing whether the contract has been processed.

The account indicator on BETS conversation \* \* showing that the contract has been "Processed" does not mean that the contract is necessarily valid. For returns filed prior to the 1998 amendments to the §25111 regulations, it only indicates that the contract has been reviewed to the extent of the information available in the return. For returns filed after 1998, the "Processed" account indicator only indicates that the contract information has been inputted onto BETS conversation \* \* . It is the auditor's responsibility to determine whether the contract is valid based on factual findings at audit.

#### ***2. Requirement To Verify That Contract Has Been Posted On BETS***

Whenever an auditor scopes or otherwise reviews a water's-edge return, the auditor must check BETS conversation \* \* to verify that the water's-edge contract is on the BETS system.

If the taxpayer fails to attach a water's-edge coversheet (Form 2426) to the face of the return, the water's-edge contract may not be identified when the return is processed. Returns that do not have a contract but meet the substantial performance criteria may also not be identified when the return is processed. The result is that the taxpayer may have a valid water's-edge election that has not been identified and posted to the BETS system. It is essential that the BETS information be updated to reflect the water's-edge election because this information may be critical for a subsequent year. In the event that the return for

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the election year is no longer available at that time, we need to be able to rely on the BETS information to determine the taxpayer's water's-edge contract status.

If an auditor identifies a return that appears to be filed on a water's-edge basis but the water's-edge election is not posted on BETS conversation \* \*, the auditor should verify the validity of the water's-edge election. If there is a valid election, the auditor should provide the election information to the individual in Technical Resource Section responsible for updating the BETS conversation.

### **3. Identifying Water's-Edge Contract Problems**

The validity of a water's-edge election should be verified by the auditor when the return is scoped for audit. Depending upon the circumstances, the auditor should take the following steps:

- **If a water's-edge contract is attached to the return:** If a contract is attached, the election is likely to be valid unless the election was not made on an original return, or unless there are inconsistent filings that are material enough to cause the group to fail the substantial performance test.
  - Check BETS conversation \* \* to verify that the election has been posted.
  - Identify all of the taxpayers included in the election and verify that they have either filed contracts or are properly included in a common parent election. If not, determine whether there has been substantial performance by the group as a whole.
  - Verify that the taxpayer(s) made the election on an original return.
  - If the election is determined to be valid but has not been posted on BETS, provide the election information to the individual in Technical Resource Section responsible for updating the BETS conversation.
- **If no water's-edge contract is attached, but water's-edge forms are attached to the return, or the return otherwise appears to have been filed on a water's-edge basis:**

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- Check BETS conversation \* \* to determine whether an election has been posted.
  - Determine whether the return represents the first year of the intended election or whether the election was made in a prior year. It may be necessary to request prior year returns in order to make this determination. However, because taxpayers were required to re-elect in 1994, it is not necessary to request returns for income years beginning before January 1, 1994.
  - If the election was made in a prior year, review any prior year audit activity. If the election has already been verified and the BETS conversation \* \* was updated, no further verification is needed. If the prior year election was not audited or if the current year is the first year of the election, determine whether the election is valid. Identify all of the taxpayers included in the election. Has each of the taxpayers filed a contract or been included in a proper common parent election? If not, was there substantial performance by the group as a whole? Was the election made on an original return?
  - If the election is determined to be valid but has not been posted on BETS, provide the election information to the individual in Technical Resource Section responsible for updating the BETS conversation.

#### ***4. The Contract Is Invalid - Now What?***

If you determine that the taxpayer has not complied with or substantially performed the election requirements, it is critical that the taxpayer be notified regarding the invalid election as soon as possible. **This requirement applies regardless of whether invalidating the election will produce a material tax effect for the year currently under review.** An invalid water's-edge election is often a multi-year problem, and taxpayers must be notified of any problems as soon as possible so that they do not continue to file on an incorrect basis.

Example 8:

Corporation W is a calendar year taxpayer that has been filing on a water's-edge basis since 1994. In August, 1999, an auditor discovers that W did not

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substantially perform the election requirements and did not have a valid election in 1994. If W had attached a completed water's-edge form (or some other objective evidence of its intent to file water's-edge) to its returns for 1995, 1996 or 1997, then it may have a water's-edge election beginning in 1995, 1996 or 1997. Otherwise, the taxpayer will not have a valid election for 1994 through 1997 and it is not possible to file amended returns to perfect the election. Furthermore, unless the taxpayer is notified about the problem in time to ensure that a valid election is made on the original 1998 return, the election may continue to be invalid for 1998.

**If the election problem has been identified on a return that has not been selected for audit**, refer the return to the individual in Technical Resource Section responsible for updating the BETS conversation. That individual will contact the taxpayer regarding the invalidation and will update the BETS conversation \* \* . The taxpayer will be asked to file amended returns on a worldwide basis.

**If the return has been selected for audit**, it is the auditor's responsibility to (1) notify the taxpayer regarding the invalidation as soon as possible in the audit process, and (2) notify Technical Resource Section so that the BETS conversation \* \* can be updated. The notification to the taxpayer should be in writing, and should explain the reason why the taxpayer did not meet or substantially perform the election requirements. If the taxpayer failed to substantially perform the election requirements in the first year of the intended election, but did have enough objective evidence to meet the substantial performance test in a subsequent year, then the letter should identify the beginning and ending dates of the contract. If the taxpayer does not agree with the auditor's determination, the taxpayer should be given an opportunity to provide information to support its position.

As stated above, invalidating a water's-edge election may have multi-year effects, and it may also affect taxpayer's tax planning and return filing positions for subsequent years. Therefore, a proposal to invalidate a water's-edge election should be taken very seriously. Auditors desiring assistance in evaluating whether the taxpayer's fact pattern constitutes substantial performance are strongly encouraged to consult with the International Specialist.

**NOTE:** (( \* \* )) = Indicates confidential and/or proprietary information that has been deleted.

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**g. Deemed Elections****1. Deemed Elections In General**

The deemed election provisions were enacted in 1989 at the request of taxpayers. These provisions were designed to prevent the invalidation of elections where a good faith determination as to the members of the affiliated group was made. The effects of the deemed election provisions are automatic -- there are no exceptions. In some situations, taxpayers intend for the deemed election provisions to apply. In other situations, the deemed election provisions create unintended results for unwary taxpayers.

Essentially, a taxpayer that becomes unitary with a water's-edge electing taxpayer will be deemed to have a water's-edge election. This situation can occur for any number of reasons. Examples of situations that can cause a deemed election include:<sup>16</sup>

- A nonelecting taxpayer may subsequently be proved, at audit, to be a unitary member of an electing water's-edge group. In this situation, an affiliate that had made a valid election could cause its nonelecting affiliates to become subject to a deemed election.
- If a corporation in a water's-edge group is subsequently found to have nexus making it a California taxpayer, it will become subject to the water's-edge election of its affiliates.
- A taxpayer may acquire a corporation that has made a water's-edge election. Unless the acquiring corporation can and does terminate its election, the acquired company's water's-edge election would be binding on the acquiring company for the remaining term of the contract. For more information regarding termination of an election in general, see Section 3.2, Water's-Edge Manual. See below for information regarding a mandatory termination in certain cases where a taxpayer's election status was affected by the 1998 regulation amendments.

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The deemed election provisions apply even if the electing taxpayer does not control the nonelecting company, or is significantly smaller than the nonelector. Furthermore, the deemed election provisions apply to every unitary member of the affiliated group. Accordingly, it is essential that every taxpayer in the worldwide unitary group be identified.

### ***2. Exception To Deemed Election: Terminations Due To 1998 Regulation Amendment***

In 1998, Regulations §25111 and 25111-1 were retroactively amended. The amendments provided relief for many taxpayers whose elections were considered invalid under the old regulations. The amended regulations also require a mandatory termination of the water's-edge election if all three of the following conditions are met:

- A taxpayer's water's-edge election for income years ending on or before January 31, 1997 was considered invalid under the old regulation, but is considered a valid election under the amended regulation.
- The taxpayer was acquired by a non-electing, non-affiliated entity prior to the effective date of the 1998 regulations. (10/31/98)
- Subsequent to the acquisition but prior to October 31, 1998, the acquired taxpayer filed its returns as though no water's-edge election was in place.

Under those conditions, the acquired taxpayer will be deemed to terminate the water's-edge election as of the time of the acquisition.

### ***3. Techniques For Identifying Deemed Election Issues***

Deemed elections can be a trap for the unwary auditor. If a deemed election is discovered late in the audit process, the auditor may have performed substantial work on the worldwide issues only to have to start over again looking at water's-edge issues. Such deemed elections are often inadvertently caused when a worldwide group acquires a water's-edge taxpayer and does not file a termination

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request. If the acquired entity is determined to be unitary with the acquirer, then all unitary taxpayers must file on a water's-edge basis from the date they are determined to be unitary until the date the election ends. Deemed elections are also common where taxpayers are filing along separate business lines and are determined to be unitary at audit, and where brother-sister corporations file separate returns and are determined to be unitary at audit.

It is essential that the auditor not only identifies all taxpayers in the unitary group, but also determines whether any of these taxpayers has made a water's-edge election. This is particularly true if the worldwide affiliated group has acquired any California taxpayers in recent years. Because water's-edge elections last for five or seven years and automatically renew, it is not sufficient to look only at new acquisitions during the audit period.

To check whether a recently acquired taxpayer had a water's-edge election in effect for an income year beginning on or after January 1, 1994, the auditor should check BETS conversation \* \*. If the taxpayer had been a member of another combined report prior to acquisition, the auditor may have to look up the taxpayer's prior relationships and check the water's-edge election status of the old key corporation.

### Example 9:

The auditor is examining the worldwide combined report of Corporation P and its subsidiaries for income years ending 12/96, 12/97 and 12/98. While researching the taxpayer's background, the auditor learns that Corporation P had acquired Corporation T, a California taxpayer, in September 1994. The taxpayer had included T in its combined report from the date of acquisition. The auditor looks up Corporation T on BETS, and learns that T had been a member of the XYZ combined report prior to being acquired by P. The XYZ group had made a water's-edge election effective January 1, 1994. Therefore, if the taxpayers in the P group did not file a timely termination request, they will be bound by the terms of T's water's-edge election from the time they became unitary with T through at least December 31, 2000.

### Example 10:

Assume the same facts as in Example 9, except that P had acquired T in 1993, and the XYZ group had a valid water's-edge election in effect at that time.

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Assuming that T was instantly unitary with the P group, the P group would have had a deemed election in 1993. However, all water's-edge contracts were rescinded for income years beginning on or after 1994. Therefore, deemed elections occurring prior to 1994 will not affect the taxpayers during the audit period.

As a final note on the deemed election issue, if a potentially combinable entity has a water's-edge election, the tax consequences of combining the entity need to be evaluated during the audit scope. If the results of combining the entity and triggering a deemed water's-edge election would substantially offset the tax potential of other issues, the auditor must take this into account in deciding whether to pursue the audit.

**NOTE:** (( \* \* )) = Indicates confidential and/or proprietary information that has been deleted.

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### ***h. Contract Period***

#### ***1. Term***

Each taxpayer must file returns on a water's-edge basis for a period of 60 consecutive months (five years) if the election is made for an income year beginning before January 1, 1994. For elections made for income years beginning on or after January 1, 1994 the election period is 84 consecutive months (seven years). In some cases, a contract will not begin on the first day of an income year because members of the combined reporting group have different fiscal year ends. When that occurs, a partial worldwide, partial water's-edge computation will be required for both the first and last income years covered by the election of the affected taxpayer. In certain circumstances, a taxpayer may be able to terminate its election prior to the normal expiration date. For a discussion of when an election may be terminated, see Section 3.2, Water's-Edge Manual, Termination of Election.

#### ***2. Short Period Returns***

If a change in accounting period results in a short period income year, the contract period is not shortened. Each month of the income year is counted toward the contract period. If a short period return(s) was filed during the contract period, it may cause a water's-edge election to end in mid-income year. Under pre-1994 contracts, the taxpayer may elect to continue filing on a water's-edge basis through the end of the income year.<sup>17</sup> However, the law section allowing that election was repealed, so the option to continue filing on a water's-edge basis through the end of the income year is not available for income years beginning on or after January 1, 1994.

#### **Example 9:**

The taxpayer elects to file on a water's-edge basis beginning on April 1, 1988 for a fiscal year ending March 31, 1989. The 60 month contract period will expire on March 31, 1993, assuming a Notice of Nonrenewal was filed. The taxpayer changes accounting periods from a March 31 year-end to a December 31 year-

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end in 1990. The contract period is for 60 months and not 5 income years. The taxpayer may elect to file on the water's-edge basis through December 31, 1993, which is the end of the last income year of the contract. If no election is made, the taxpayer must file on a hybrid water's-edge/worldwide combination method for the income year ending December 31, 1993. This is done by using the water's-edge method for the first 3 months and a worldwide combination method for the last 9 months of the income year.

4/1/88	3/31/89	3/31/90	12/31/90	12/31/91	12/31/92	3/31/93	12/31/93
w/e	w/e	w/e	w/e	w/e	w/e	w/e	w/e
		short			w/e	or	w/w
		period					

### 3. Different Fiscal Years

If two (or more) taxpayers engaged in a unitary business wish to make a water's-edge election, but each has a different fiscal year end, the election begins as of the first day of the income year of the last member of the group to elect. The combined report will reflect a hybrid water's-edge/worldwide combination method.<sup>18</sup>

Each taxpayer member of the water's-edge group will make the election upon its initial return for the income year. The election will become effective as of the beginning of the income year of the last member of the group to file its return and election. The 84-month (60-month under prior Section 25111(a)) election period for each member of the group will run from the date that the election becomes effective (i.e. the beginning of the income year of the last member to elect).

Example 10:

Corporation A's fiscal year ended March 31, 1988 and 1989. Corporation B's year ended December 31, 1988. The water's-edge election may not be made for income years beginning before January 1, 1988. Therefore, the first full eligible year for B is the year ended December 31, 1988. A will be the last member of the group to elect, effective for its income year ended March 31, 1989. Thus, the water's-edge group's election begins April 1, 1988, the beginning of A's income

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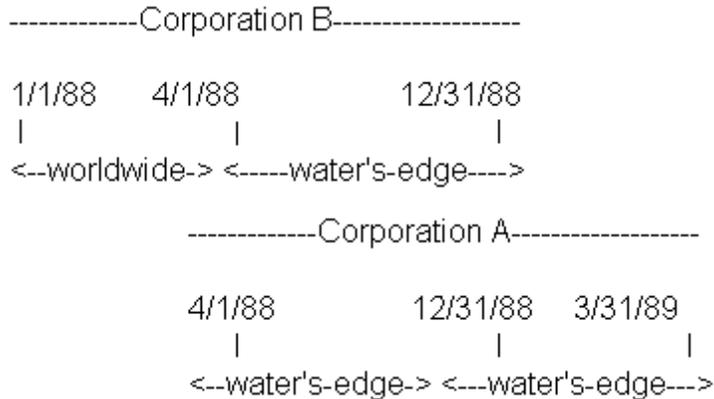
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year. In B's tax return for 1988, the period January 1 through March 31, 1988 must be given worldwide combination treatment because it includes a period of time preceding the beginning of the income year of the last member of the group to elect.



If a non-taxpayer member of the water's-edge group has a different year-end from that of the taxpayer members, it will have to fiscalize its income to the accounting period of the principal member. However, the general rule for determining contract start dates for taxpayers with different year-ends will not apply. Non-taxpayer members of the water's-edge group are not required to make the water's-edge election and, therefore, their inclusion in the water's-edge combined report will not affect the start date of the contract. This applies whether the non-taxpayer member is a fully included domestic corporation or a partially included foreign corporation.

If a foreign corporation with a different fiscal year-end is unitary but fully excluded from the water's-edge group, it will not normally have to perform any fiscalization during the election term. However, it will have to fiscalize its income to the accounting period of the principle member in order to determine how much income to include in the worldwide combined report prior to the first year of the election and after the last year of the election.

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-----WATER'S-EDGE ELECTOR-----IYE 12/31

1/1/88	4/1/88	12/31/88
<-----water's-edge----->		

-----FOREIGN AFFILIATE-----IYE 3/31

4/1/87	1/1/88	4/1/88	12/31/88
9/12 would be included in w/w for 12/87	Zero included - 3/12 would not be included in w/e for IYE 12/88	Zero included in w/e	

#### 4. Taxpayers With 52-53 Week Accounting Periods

Determining the effective date of a statute for a taxpayer that regularly keeps their books on 52-53 week accounting period can be confusing since the last day of the taxable year can change from year to year. For purposes of determining the effective date or the applicability the water's-edge election provisions to a 52-53 week taxpayer, the taxpayer's income year will be treated as if it began on the first day of the month beginning nearest to the first day of the 52-53 income year.<sup>19</sup> The effect of this rule on the water's-edge provisions can be illustrated by the following example.

Example 11:

Status Corporation regularly maintains its books and records using a 52-53 week income year ending on a Sunday. Status Corporation made a water's-edge election for its income year which began December 27, 1987 and ended December 24, 1988. Although Status Corporation's income year begins prior to the January 1, 1988, the effective date of the statute, the election is nevertheless considered valid because its income year is treated as if it began on or after January 1 for purposes of determining the statute's effective date.

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Status Corporation did not file a Notice of Nonrenewal. Accordingly, Status Corporation's election was rescinded effective for income years beginning on or after January 1, 1994. Accordingly they must reelect water's-edge treatment to continue filing on that basis for income years beginning on or after January 1, 1994. As a result of reporting on a 52-53 week basis, Status' income year ended December 26, 1993. Its next income year began December 27, 1993 and ended December 25, 1994. At first glance, it would appear that Status' was bound to use the old election rules for both the income year ending December 26, 1993, and the income year ending December 25, 1994, since both income years began prior to January 1, 1994. However, the effective date provisions for 52-53 week taxpayers treat the income year ending December 25, 1994 as if it began on or after January 1, 1994. Accordingly, Status Corporation's contract would be rescinded effective for its income year ending December 26, 1993. A new water's-edge election would need to be made and the new water's-edge election provisions would apply to the income year beginning December 27, 1993 and ending December 25, 1994, even though its income year actually began prior to January 1, 1994.

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### *i. Automatic Renewal*

The contract automatically renews on its anniversary date and extends the 84 month (or 60 month under the prior Section 25111(a)) contract period an additional 12 months unless a Notice of Nonrenewal is filed.<sup>20</sup>

#### **1. Anniversary Date**

The contract is automatically extended by 12 months on the anniversary date unless a Notice of Nonrenewal is filed.<sup>21</sup>

The contract anniversary date is the due date, or extended due date, of the original return on which the election is actually made. If the election is made on the due date of the return (without extension), then the anniversary date for that contract will be the original due date of the return without extension. If the election is made after the original due date of the return but within the extension period, then the anniversary date will be the extended due date of the return.

Paperless extensions are conditioned upon the return being filed within the extension period (see FTB Notice 92-11). Therefore, no extension is considered to have been allowed if the return is delinquent (filed after the 7 month extension period). Accordingly, if a water's-edge election is made on a delinquent return, the anniversary date will be the original due date.

The original due date or extended due date of the return on which the water's-edge election is made, whichever is later, will always designate the anniversary date. The anniversary date (or renewal date) is the same date every year thereafter during the contract period.<sup>22</sup> The anniversary date of any subsequent contracts entered into will depend upon the filing date (original due date or extended due date).

Examples:

1. Return's original due date - March 15, 1995  
Date Filed - March 15, 1995  
Anniversary Date - March 15, 1996 and each March 15 thereafter
2. Return's extended due date - October 15, 1995  
Date Filed - September 20, 1995  
Anniversary Date - October 15, 1996 and each October 15 thereafter

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3. Return's original due date – March 15, 1995  
Date Filed – November 30, 1995 (delinquent)  
Anniversary Date – March 15, 1995, and each March 15 thereafter

For taxpayers with different fiscal year ends, the anniversary date of the contract for each taxpayer will be the later of the original due date of its return or the extended due date for purposes of filing a Notice of Nonrenewal. However, if the common parent files the Notice of Nonrenewal on behalf of its subsidiaries, the notice must be filed by the earliest anniversary date in order to be effective for all taxpayer members of the group.

### **2. Notice Of Nonrenewal**

At the option of the taxpayer, a Notice of Nonrenewal can be filed which will limit the contract to the number of months remaining under the existing contract.

#### **A. WHEN TO FILE**

To avoid automatic renewal a taxpayer must file a written notice not to renew at least 90 days before the anniversary date. The Notice of Nonrenewal must be filed separate from the tax return. The time of filing will be the date that it is delivered to FTB either in person or by mail. The date of postmark will constitute date of delivery.<sup>23</sup> Many taxpayers file the Notice of Nonrenewal at the same time as the original contract, thus ensuring that the contract is limited to only 84 months (60 months under the prior Section 25111(a)) with no automatic renewal feature.

A Notice of Nonrenewal does not affect the taxpayer's ability to make new elections. Theoretically, the taxpayer can file a contract and a Notice of Nonrenewal every year. This would have the same effect as the automatic renewal.

Example 12:

Filing date of Original Contract - October 15, 1995  
Anniversary Dates - 10/15/96, 10/15/97, 10/15/98, 10/15/99, 10/15/2000  
Income years covered by original contract - 12/94, 12/95, 12/96, 12/97, 12/98, 12/99, 12/2000

To limit the contract to 84 months ending December 2000, the Notice of Nonrenewal must be filed between October 15, 1995 and July 17, 1996 (90 days

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prior to October 15, 1996). After July 17, 1996, the contract automatically renews another 12 months through December 2001. If a Notice of Nonrenewal is not filed before July 17, 1997, the contract will be extended by an additional 12 months, and so forth.

### ***B. WHAT TO FILE***

The taxpayer will file a Notice of Nonrenewal, FTB Form 1116 to stop the automatic renewal of the contract period. The form cannot be filed with the taxpayer's return. Rather, it must be submitted to the FTB at the address indicated in FTB 100-WE Booklet for the Notice of Nonrenewal to be considered valid.

### ***C. WHO MUST FILE***

Similar to the requirement that all taxpayers must elect to file on a water's-edge basis, all taxpayers which are members of a water's-edge group must consent to the filing of the Notice of Nonrenewal. However, the "substantial performance" provisions do not apply to Notices of Nonrenewal.

A common parent can file a Notice of Nonrenewal on behalf of all the taxpayer members. If the parent of a controlled group filing a consolidated federal return files the Notice of Nonrenewal, it will apply to all California taxpayers that were in the consolidated group. If there are other members of the water's-edge group in addition to the consolidated group, they must each file their own Notice of Nonrenewal.

### ***D. EFFECTS OF NOTICE OF NONRENEWAL***

Filing a Notice of Nonrenewal does not terminate the requirement of filing water's-edge returns until the 84 month contract period expires (60 month for contracts entered into for income years beginning prior to January 1, 1994). A Notice of Nonrenewal merely limits the filing requirement to the number of years remaining on the contract. In addition, filing a Notice of Nonrenewal does not prevent a taxpayer from making another water's-edge election for a subsequent income year. If overlapping contracts are in effect, a Notice of Nonrenewal will apply for the contract(s) that was filed concurrent with or prior to the filing of the notice but will not affect subsequent contracts.

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### ***j. Changes In Affiliations<sup>24</sup>***

Taxpayers will generally be bound by any election they entered into or were deemed to have entered into for entire term of the contract. For example, the water's-edge election is an attribute that will carry over in a tax-free reorganization. The taxpayer will be bound by the election in the following situations.

#### ***1. Subsequently Taxable***

A member of a water's-edge group which becomes subject to tax in California subsequent to the election by the group will be deemed to have elected. Or, if subsequent to the election, a member of the water's-edge group is determined to have been subject to tax, that bank or corporation will be deemed to have elected.<sup>25</sup>

#### ***2. Subsequently Determined To Be A Member Of The Water's-Edge Group***

If, pursuant to a FTB audit, a non-electing taxpayer is proved to be a member of the water-edge group, then the nonelecting taxpayer will be deemed to have elected.<sup>26</sup>

Example 13:

Taxpayer A filed its original return on separate company basis and elected water's-edge. Taxpayer B filed its return on a separate company basis and did not elect water's-edge. As a result of an FTB audit determination, NPAs are issued to combine A and B in a single unitary business. B is deemed to have elected and is bound by A's election.

The election will be effective as of the date of the election of the other members of the water's-edge group.

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### **3. Subsequently Becoming A Member Of The Water's-Edge Group**

A taxpayer which becomes a member of a water's-edge group subsequent to an election by the group will be deemed to have elected and will be bound by the election for the remaining term of the contract.<sup>27</sup>

Example 14:

Corporation A elected to file on a water's-edge basis for five years beginning in 1989. Corporation B did not make an election and files its returns for years prior to 1992 on a worldwide basis. On January 1, 1992, A and B become engaged in a unitary business. For 1992 and 1993, B is deemed to have elected and will be subject to the terms of A's election and contract. B must pay the election fee for the income years 1992 and 1993.

### **4. Reorganizations**

A reorganization will not itself cause the termination a water's-edge election. The reorganization of a water's-edge taxpayer is not a terminating condition unless the acquiring entity otherwise meets the termination conditions set forth in RTC 25111(b).<sup>28</sup> (See Section 3.2, Water's-Edge Manual for more information). Thus, for example, if a water's-edge taxpayer is a party to a reorganization and as a result ceases to exist, the water's-edge election carries over to the acquiring entity.

If a water's-edge taxpayer and a nonwater's-edge taxpayer consolidate and form a new entity, the new entity will be bound by the water's-edge contract if its activities constitute a single business. If the two merged entities are not unitary, there will be a water's-edge division and a nonwater's-edge division. Thus, assuming both divisions have taxable nexus in California, one division would compute its taxable income on a water's-edge basis and the other would file on a worldwide basis.

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### Example 15:

Corporation A is not unitary with Corporation B. If Corporation B merges into Corporation A, and Corporation B is maintained as a separate non-unitary division after the merger, the election would not be binding on the nonunitary division.

Should the divisions become unitary, the water's-edge election would become binding on the entire entity at that time.

### **5. Asset Acquisitions**

In general, the purchase of a water's-edge taxpayer's assets by a nonwater's-edge taxpayer will not bind the nonwater's-edge taxpayer, assuming the asset acquisition is not a transaction described in IRC Section 368 (reorganization).

If a non-water's-edge taxpayer purchases stock of a water's-edge taxpayer and makes an election pursuant to IRC Section 338, then the stock purchase is treated as a purchase of the target's assets for all purposes of the code. Consequently, the water's-edge election will not carryover after a 338 election.

### **6. Liquidations**

In general, the water's-edge election will carry over to the distributee(s) in a complete liquidation to which IRC Section 332 applies. The water's-edge election will carryover if the recipient(s) of the liquidating distribution:

- a) Directly or indirectly owns more than 50% of the stock of the liquidating taxpayer immediately prior to the distribution(s), and
- b) is itself a California taxpayer, or becomes a taxpayer as a result of the receipt of the liquidating taxpayer's assets.<sup>29</sup>

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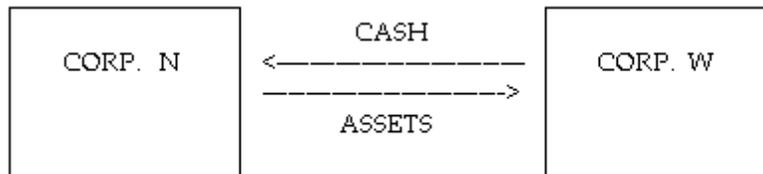
**7. Examples**

The following are some merger, reorganization, asset acquisition and liquidation situations and their effects on the water's-edge election.

W = WATER'S-EDGE TAXPAYER X = NEW ENTITY  
N = NON WATER'S-EDGE TAXPAYER  
W/E = WATER'S-EDGE W1 & W2 = 2 WATER'S-EDGE TAXPAYERS

SITUATION 1:

W purchases N assets. (W & N are unrelated entities.)



EFFECT: W/E election remains in effect for Corporation W. Corporation N is not effected by W/E election.

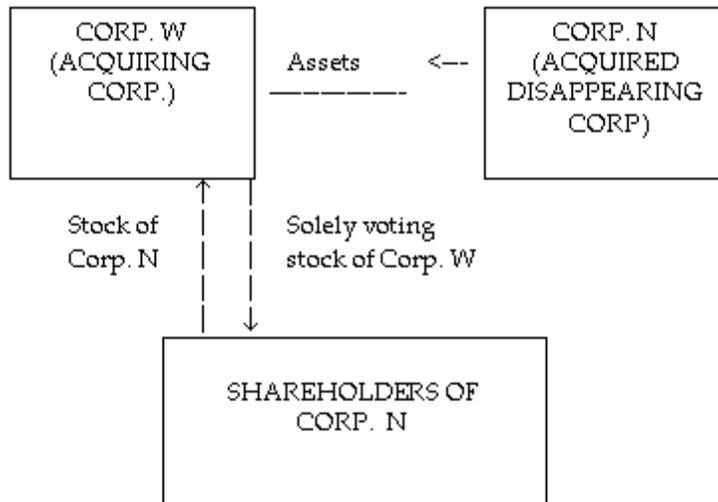
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### SITUATION 2:

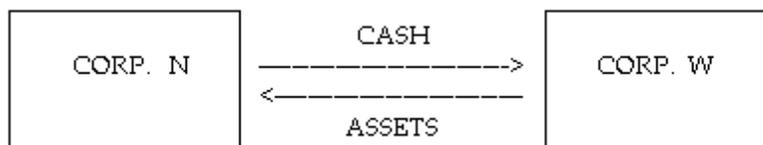
W acquires N stock and liquidates N



EFFECT: W/E election continues in effect for Corporation W. W/E election in effect for N if N is unitary with W. (N may have instant unity with W). W may terminate election if criteria met.

### SITUATION 3:

N purchases W's assets.



EFFECT: W/E election remains in effect for Corporation W. Corporation N is not effected by W/E election.

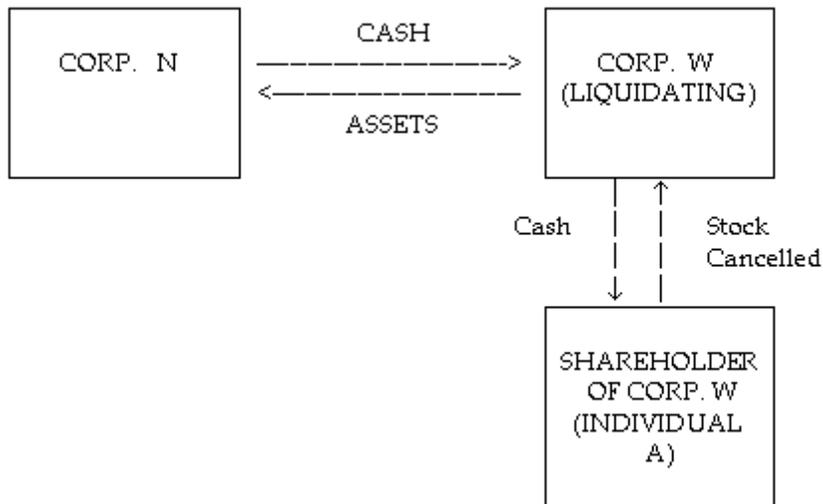
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### SITUATION 4:

N purchases W assets and W liquidates (W's shareholder is individual A. The transaction does not qualify as a reorganization and N did not control W or vice versa)



EFFECT: W/E election is terminated at date of dissolution of Corporation W. Corporation N is not bound by the water's-edge contract by acquiring Corporation W's assets.

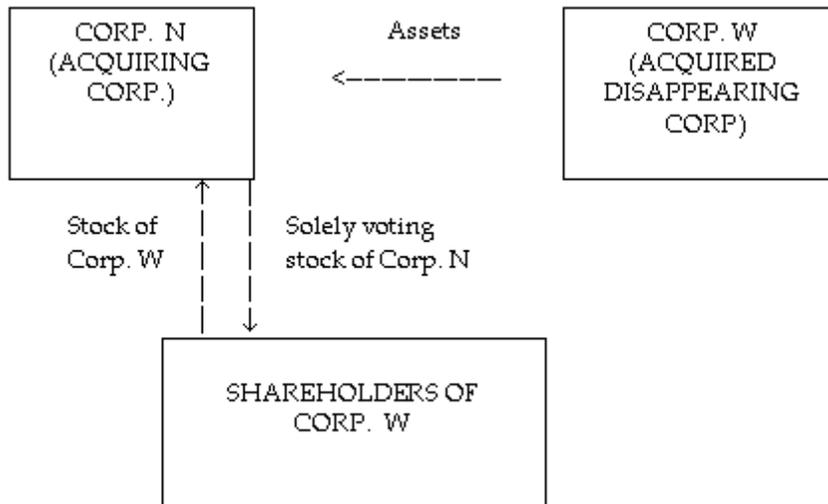
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### SITUATION 5:

N acquires W's stock and liquidates W .



EFFECT: Corporation N is not bound by W/E election unless it becomes unitary with activities of Corporation W. W/E election remains in effect for activities of former Corporation W. If Corporation W's activities become a nonunitary operating division, it will separately compute its income on a W/E basis until it becomes unitary with Corporation N or the contract expires, whichever comes first. Corporation W may terminate election if the criteria for termination is met.

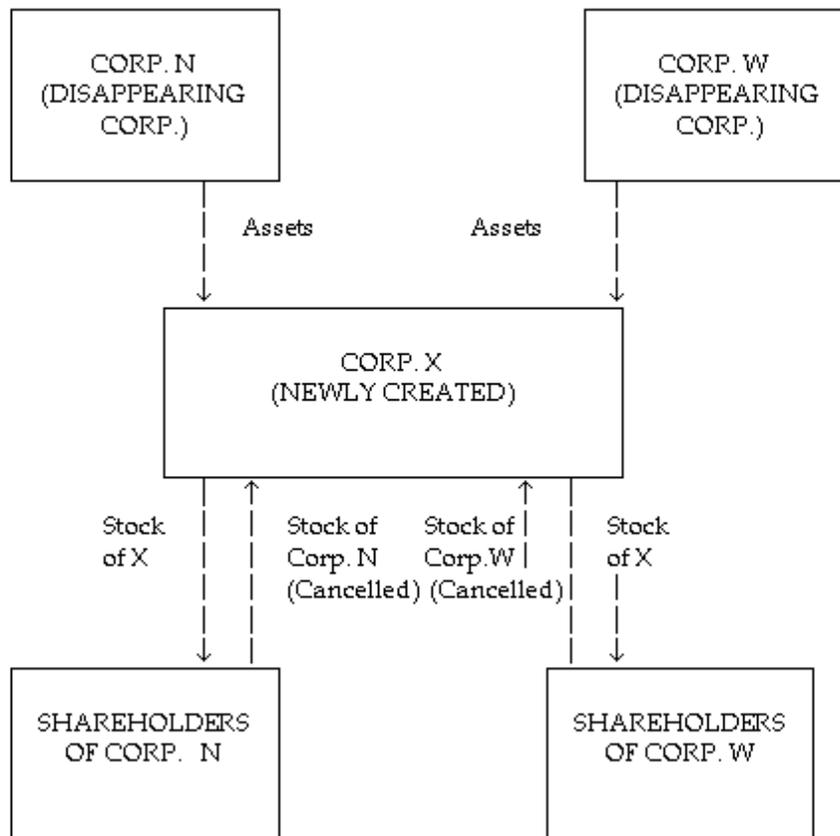
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## SITUATION 6:

W and N merge and form X



EFFECT: W/E election applies to new entity. If W and N are not unitary, N will become a division not subject to the W/E election. Corporation W may terminate election if termination criteria is met.

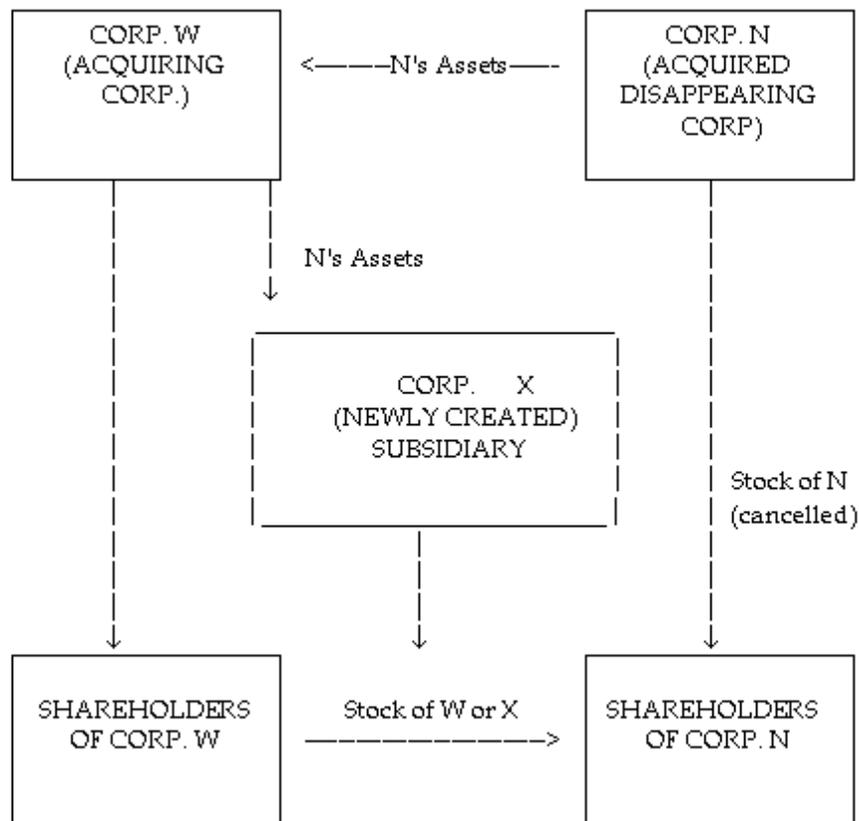
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### SITUATION 7:

W acquires N assets in reorganization and N liquidates. W transfers assets to X.



EFFECT: W/E election applies to new entity, Corporation X, assuming it is unitary with W. Corporation W may terminate its election if termination criteria is met.



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### SITUATION 9:

Corporation W1 and Corporation W2 merge into either Corporation W1, Corporation W2, or Corporation X.

### EFFECT:

Two W/E contracts are in effect. Generally, the taxpayer will be subject to the longest election period.

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### ***k. Consent To Provide Information***

#### ***1. The Consent, In General***

##### ***A. PURPOSE OF CONSENT***

The purpose of the consent in the contract is to prevent issues of service and jurisdiction from being brought up during an audit or administrative review by the FTB, Board of Equalization or judicial proceedings. The consent does not waive any other defenses or expand or restrict any rights the taxpayer may have.<sup>30</sup>

##### ***B. CONSENT PERIOD***

- A. The consent is made with the filing of the return containing the water's-edge contract.<sup>31</sup>
- B. The consent applies to all open years for which the water's-edge election is in effect and remains in effect for each year open for adjustment.

##### ***C. CONSENT LIMITATION***

The consent is limited to providing the following.

- A. Information necessary to review or adjust income or deductions under the following IRC sections and their regulations.
  - 1. IRC Section 482, Allocation of Income and Deductions among taxpayers.
  - 2. IRC Section 861, Income from Sources within the United States.
  - 3. IRC Section 951-964, Subpart F rules for CFCs.
  - 4. Provisions similar to any of the above.
- B. Information necessary to conduct an investigation with respect to any unitary business involving the taxpayer.<sup>32</sup>

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### **2. Depositions**

#### **A. TAKING OF DEPOSITION**

The consent to the taking of depositions applies to key employees or officers of a domestic corporation.<sup>33</sup>

1. A domestic corporation is defined as a bank or corporation which is incorporated in the U.S. or has an office in the U.S. (Any foreign bank and corporation with more than 20% of its income and factors in the U.S. would probably have an office in the U.S. and would meet the criteria.)
2. A foreign bank or corporation included in the combined report to the extent of its income attributable to sources within the U.S. is also considered to be a domestic corporation to the extent of its U.S. activities.<sup>34</sup> (The auditor may find a problem in gathering complete records from the foreign entity.)
3. The consent does not apply only to employees of the taxpayer, but may include employees of any affiliated domestic corporation and former employees of the taxpayer.

#### **B. KEY EMPLOYEE OR OFFICER**

A key employee or officer is one who would be designated by the corporation at the time of a discovery request in a court proceeding as one of the three most knowledgeable individuals.<sup>35</sup>

1. A key employee or officer would include: manager, supervisor, vice president, director, etc., of a corporate or divisional department or function.
2. The individual does not have to be located in the U.S. But may be:
  - a. an individual who maintains an office in the U.S.;
  - b. an individual whose activities are directed from the U.S.;
  - c. an individual who directs the activities of an office in the U.S.
3. A former employee or officer may be designated. However, should the individual refuse to be deposed, a current employee must be designated.

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### **C. TIME OF DEPOSITION**

The time for taking deposition is normally subject to the agreement of the parties. But if there is no agreement, a reasonably convenient time would be the 60th day after the mailing of the notice of deposition.

### **D. LOCATION OF DEPOSITION**

The location where the deposition is to be taken is normally subject to the agreement of the parties. If there is no agreement, then a reasonably convenient place is either the residence of, or headquarters of, the individual to be deposed if it is located in the U.S., or if not located in the U.S., the North American headquarters of the water's-edge group.

### **3. Subpoenas Duces Tecum**

The consent requires acceptance of subpoenas duces tecum by the taxpayer. The term acceptance means that the taxpayer will not bring up issues of jurisdiction or service against FTB. Thus, the taxpayer waives its defense as to whether the subpoena was issued to the proper entity or at the proper place, etc. It does not necessarily mean that the taxpayer will comply with the production of the documents, only that the taxpayer will accept the subpoena. The acceptance of subpoenas applies only with regard to the reasonable production of documents.

#### **A. PRODUCTION OF DOCUMENTS<sup>36</sup>**

This section covers what information FTB is entitled to under the water's-edge contract.

1. The consent does not in any way limit the FTB's capacity to request any and all documentation necessary to ascertain the correctness of any return under RTC Section 19504.
2. Documents that may reasonably be required to be produced are relevant or material documents under the direct or indirect control of the person subject to the subpoena. (Documents are under the indirect control of a person when they are under direct control of an individual who is beneath

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- the person subject to the subpoena in a chain of command.)
3. An FTB request is presumed reasonable if it can be established that the documents have been removed, retained or stored outside the U.S. in an attempt to avoid production.

### ***B. TAXPAYER OBJECTION TO PRODUCTION OF DOCUMENTS***

The taxpayer may raise the following objections with respect to the production of documents requirement by bringing an action in court to quash the request on the grounds of:

- 1) privilege (privilege means attorney/client, doctor/patient, or some other judicially or statutorily privileged communications relationship);
- 2) unreasonable burden (the fact that documents are located outside the U.S. is not unreasonable burden to produce);
- 3) lack of specificity in the description of the documents.

There are other objections that could be made, all of which would be subject to court review. A judge, rather than the auditor, will determine the correctness of the objection.

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### *I. Treatment Of Foreign Dividends As Business Income*<sup>37</sup>

The water's-edge law and regulations pertaining to dividends as business income were inserted to prevent the taxpayer from arguing that a State may not tax dividends earned outside its borders unless it can be shown that a unitary business relationship existed with an entity within the State. (ASARCO v. Idaho State Tax Commissioner, S.Ct., June 29, 1982). For water's-edge purposes, the consent requires the taxpayer to stipulate that dividends are deemed to be business income under the following conditions:

The taxpayer agrees to business income treatment of dividends received from:

- A. over 50 percent owned entities (either directly or indirectly) engaged in the same general line of business as the members of the water's-edge group, or
- B. a bank or corporation (not required to be owned more than 50 percent by a member(s) of the water's-edge group) which:
  - 1. is a significant source of supply to or a significant purchaser of the output of the members of the water's-edge group, or
  - 2. sells a significant portion of its output or obtains a significant part of its raw materials or input from members of the water's-edge group.

For purposes of the consent to business treatment of dividends, "significant" means an amount equal to or greater than 15 percent applied to the purchases or sales of individual banks or corporations and not to the water's-edge group.

NOTE: "Output" refers to the tangible property produced or sold or the service provided. Amounts are to be considered cumulatively and not by category.

"Source of supply" and "input" refer to the purchase of raw materials or semi-finished products for manufacturing or tangible property for resale. Amounts are to be considered cumulatively and not by category.

All other dividends will be classified as business or nonbusiness income in accordance with the general California rules as set forth in CCR Section 25120.

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### *m. Summary*

In this section you have reviewed the items dealing with the election and contract. You have been made aware of the filing requirements, the effect of the water's-edge election when there are changes in affiliations, and an overview of the taxpayer's obligations to provide certain information. In the next section, you will look at the requirements and methods for terminating the election prior to the end of the contract period.

Some of the more technical and significant areas that have been covered in detail are as follows.

1. What are the requirements for a valid water's-edge election.
2. What effect mergers, reorganizations, asset acquisitions, and liquidations have upon the election.
3. Who must file the water's-edge contract.
4. What six items the taxpayer commits to by electing water's-edge:
  - a. Filing seven years on a water's-edge basis;
  - b. Agrees to business income treatment of foreign dividends;
  - c. Consent to procedures for obtaining information through depositions and subpoenas;
  - d. Furnishing certain information upon request;
  - e. Paying an annual fee (for pre-1994 years), and
  - f. Filing a DDS every three years (for pre-1994 years).

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### **Footnotes**

1. RTC Section 25110(b)(1)
2. 229 Cal. App. 3d 784.
3. 195 Cal. App. 3d 326.
4. CCR Section 25110(b)(1)
5. CCR Section 25110(b)(5)
6. RTC Section 25110(b)(2)
7. RTC Section 25110(b)(2)(B)
8. CCR Section 25111(a)(2) and CCR Section 25111-1(a)(2)
9. CCR Section 25111(c) and 25111-1(c)
10. CCR Section 25111(d)(1) and 25111-1(d)(1)
11. RTC Section 25111(a) and CCR Section 25111-1(e)
12. RTC 25111.1(a)
13. RTC Section 25111.1(b)
14. RTC Section 25110(b)(2)(B)
15. Public Notice dated April 24, 1989 - FTB Notice 89-197
16. RTC 25111(a) and CCR Sections 25111(d)(2) and 25111-1(d)(2)
17. CCR Section 25115(a)(5)(B). Because the election to extend the water's-edge contract through the end of the income was only contained in the election fee regulations, which were repealed for income years beginning on or after January 1, 1994, there is no provision for income years beginning on or after January 1, 1994 that would allow the taxpayer to extend its contract beyond the original election period.
18. CCR Sections 25111-1(g) and 25111(g)
19. IRC 441(f)(2)(i)
20. RTC Section 25111(a) and (d)
21. CCR 25111(h)(1) and Section 25111-1(h)(1)
22. CCR Section 25111(b)(2) or CCR Section 25111-1(b)(2)
23. CCR Section 25111(h)(2)(A) and 25111-1(h)(2)(A)
24. CCR Section 25111(d)(2) and 25111-1(d)(2)
25. CCR Section 25111(d)(2)(A) and 25111-1(d)(2)(A)
26. CCR Section 25111(d)(2)(B) and 25111-1(d)(2)(B)
27. CCR Section 25111(d)(2)(C) and 25111-1(d)(2)(C)
28. CCR Section 25111(d)(2)(D) and 25111-1(d)(2)(D)
29. CCR Section 25111(d)(2)(E) and 25111-1(d)(2)(E)
30. CCR Section 25110(c)(2)(A)(iii)
31. CCR Section 25110(c)(2)(A)(i)
32. CCR Section 25110(c)(2)(A)(iv)

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated**

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33. CCR Section 25110(c)(2)(C)
34. CCR Section 25110(c)(2)(C)(ii)
35. CCR Section 25110(c)(2)(C)(iii)
36. CCR Section 25110(c)(2)(D)
37. CCR Section 25110(c)(3)

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### Section 3.2 Water's-Edge Election And Contract - Termination Of Election

#### ***Contents:***

- a. INTRODUCTION
- b. TERMINATION OF ELECTION
  - 1. Termination Without FTB Permission
  - 2. Termination With FTB Permission
- c. TIME PERIOD FOR FTB TO TAKE ACTION
- d. CONDITIONS FOR REQUEST TO TERMINATE AN ELECTION
- e. RE-ELECTIONS
- f. DISREGARDING THE ELECTION BY FTB
- g. SUMMARY

#### ***References:***

Revenue & Taxation Code Section 25111 (pre- and post-1994)  
Revenue & Taxation Code Section 25111.1  
California Code of Regulation Section 25111  
California Code of Regulation Section 25111.1

#### ***Training Objectives:***

By the end of this section the reader will be able to:

- 1. Determine the circumstances under which an election may be disregarded or terminated, and
- 2. Know the changes to the water's-edge provisions affecting elections made for income years beginning on or after January 1, 1994.

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### **a. *Introduction***

In the last section, we discussed the water's-edge contract and how a taxpayer makes an election. In this section, we will discuss the requirements and what the taxpayer must do to terminate the election prior to the contract expiration.

With the recent changes to the water's-edge law, which are effective for income years beginning on or after January 1, 1994, the taxpayer's ability to terminate an election was curtailed. In addition, the law was also modified to repeal the FTB's ability to disregard the election.

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### ***b. Termination Of Election***

Terminating the election is the only way to end an election before the contract expires. A request to terminate a water's-edge election, which may or may not require FTB approval, is originated by the taxpayer. Once the termination is in effect, neither the taxpayer nor any of its affiliates will be bound by the contract unless another contract is entered into for a subsequent period.

Mergers, reorganizations, liquidations, and acquisitions may affect the taxpayer's circumstances so that the taxpayer may wish to terminate the election. See Chapter 3.1(j), Water's-Edge Manual for more information.

#### ***1. Termination Without FTB Permission***

For elections made for income years beginning **prior** to January 1, 1994, a taxpayer may request to terminate the election **without** FTB permission if:

1. A taxpayer is acquired by an unaffiliated larger entity which has not elected.<sup>1</sup>
2. A taxpayer ceases to be affiliated with all banks or corporations which were excluded from its combined report because of the water's-edge election, and the taxpayer itself is not doing business outside the U.S.<sup>2</sup>
3. The FTB issues an NPA or NTD (Notice of Tax Due) based upon a substantial modification to the composition of the water's-edge group.<sup>3</sup>

For income years beginning **on or after** January 1, 1994, the only way that a taxpayer may request to terminate a water's-edge election without FTB permission is if the taxpayer is acquired by an unaffiliated larger entity which has not elected.<sup>4</sup>

#### ***A. ACQUIRED BY A LARGER ENTITY<sup>5</sup>***

The taxpayer may request to terminate the election if the taxpayer is acquired by an unaffiliated non-electing entity or group of entities that has a larger equity capital than the taxpayer. The term "taxpayer" means an individual bank or

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corporation filing on a water's-edge basis. It does not mean the water's-edge group or all members of the water's-edge group.

Termination under this condition will be effective for the income year immediately succeeding the income year of acquisition.

Equity capital includes:

- (a) issued stock of any class
- (b) paid-in capital
- (c) retained earnings or earned surplus

These amounts are taken from the balance sheet for that entity for the immediately preceding accounting period.

Example 1:

Corporation A, B, and C elected to file on a water's-edge basis. Corporation B is acquired by a larger entity. Corporation A and C must continue filing on a water's-edge basis, but Corporation B may elect to terminate the contract for itself only.

### ***B. CEASES AFFILIATION<sup>6</sup>***

For income years beginning prior to 1994, a taxpayer may request to terminate the election if the taxpayer itself is not doing business outside the United States and ceases to be affiliated with all banks and corporations (due to a sale or other disposition) which:

- (a) were engaged in a unitary business with the taxpayer, and
- (b) had been excluded from the combined report due to the water's-edge election.

A taxpayer may terminate its election only if its affiliations with all corporations doing business beyond the water's-edge cease. In other words, if a wholly domestic California taxpayer is affiliated with three foreign corporations and ceases to be affiliated with one of them, the election could not be terminated. (Exception: If the change resulted in a significant disadvantage to the taxpayer

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which could not reasonably have been foreseen at the time the election was made, the taxpayer may request FTB's permission to terminate).

The termination is effective for the income year immediately succeeding the income year that the taxpayer ceased to be affiliated.

Example 2:

The water's-edge group consists of domestic Corporations A, B and C, all of which have an income year ending December 31, 1990. Corporation D, the only foreign affiliate, is sold April 30, 1990. The termination would be effective for the income year beginning January 1, 1991.

### **C. SUBSTANTIAL MODIFICATION<sup>7</sup>**

For income years beginning prior to 1994, a taxpayer may request to terminate the election if, as a result of an FTB audit, a substantial modification is made to the composition of the water's-edge group as originally filed. The change must occur directly as a result of the FTB's addition or elimination of an entity(s), or part of an entity, from the water's-edge group.

A taxpayer's addition or elimination of a member of the water's-edge group in an amended return does not qualify for termination under RTC Section 25111(b)(4).

When the FTB makes a change to either add or eliminate a part of an entity, one entity, or more than one entity, it is not necessary that the entity be engaged in activities in California in order for the change to constitute a substantial modification.

"Substantial" means the change must give rise to either:

- 1) a 25% change in the water's-edge group's:
  - a. amount of combined business income,
  - b. denominator of the property factor,
  - c. denominator of the payroll factor, or
  - d. denominator of the sales factor, or
- 2) a determination that entities that were excluded from the water's-edge combined report by virtue of the water's-edge election were not unitary and

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therefore could have been excluded from the combined report even if the group had not made a water's-edge election.

Termination is effective for the income years beginning on or after January 1 of the year in which the taxpayer receives the notice of deficiency.

### Example 3:

A taxpayer makes a water's-edge election and files its California return based upon its determination that entities A, B, C and D are California taxpayers engaged in a unitary business. The election allows the taxpayer to exclude entities E, F and G from the combined report used to determine its tax. E, F and G are engaged in a unitary business with D and have no activities with A, B and C. Upon audit it is determined D is not engaged in a unitary business with A, B and C.

D would still be bound by the water's-edge contract unless the 25% change criteria is met because D is still unitary with foreign entities excluded from the combined report solely by reason of the water's-edge election. A, B, and C could terminate since they are no longer in a unitary group with foreign affiliates.

### Example 4:

The composition of a water's-edge group for whom an election is in effect for income years 1988 through 1992 is substantially modified by the FTB effective for 1988 and 1989 in an audit determination dated January 15, 1992. The taxpayer may terminate the election with respect to 1992, but such termination has no effect with respect to 1988 through 1991.

## ***D. WHAT TO FILE<sup>8</sup>***

The taxpayer must file FTB Form 1117, Request to Terminate Water's-Edge Election. The request must be filed separate from the return, and must be made no later than the due of the return for the income year succeeding the income year the event took place.

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### **2. Termination With FTB Permission<sup>9</sup>**

A taxpayer may request to terminate the election **with** FTB permission under certain conditions. The taxpayer must demonstrate to the satisfaction of the FTB that the requirement to file returns on the water's-edge basis for the remaining term of the contract will result in a significant disadvantage to the taxpayer. Furthermore, the disadvantage must be the consequence of an extraordinary or significant event that could not have been anticipated at the time the original election was made.

"Significant disadvantage" includes a material difference between California tax liabilities using the water's-edge method (including the election fee) and the worldwide method. The material difference must be demonstrated by reasonable estimates that take into account all pertinent and readily available information. The difference must be shown with respect to the aggregate tax liabilities of all members of the water's-edge group that are subject to tax in California.

An extraordinary and significant event includes but is not limited to:

1. Changes in ownership, including the acquisition of the taxpayer directly or indirectly by a new owner, or the acquisition of new subsidiaries, or a reorganization or sale resulting in a disaffiliation of the taxpayer. The taxpayer may request permission to terminate the election if it is acquired by an unaffiliated non-electing entity that is smaller in terms of equity capital than is the taxpayer. (If the acquiring entity is larger the taxpayer does not need permission to terminate its election. See Part 1A of Section 3.2(b), Water's-Edge Manual)
2. Unconstitutionality of worldwide combined reporting. (This is no longer available to the taxpayer as the U.S. Supreme Court has decided that worldwide reporting is not unconstitutional.<sup>10</sup>)

Any request to terminate with FTB permission will be effective for the first income year whose return is due (including extensions) after the request is filed. The FTB may grant the request effective for some later income year, but requests may not be retroactive.<sup>11</sup>

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### **A. AGREE TO CONDITIONS**

The taxpayer must also agree to certain conditions when it requests permission to terminate its election. These conditions include certain treatment with respect to dividends, gains, and losses, and will be covered under Section 3.2(d), Water's-Edge Manual.

### **B. What And When To File Termination Request<sup>12</sup>**

The taxpayer must file FTB Form 1117, Request to Terminate Water's-edge Election, by the due date or extended due date of the return for the income year immediately succeeding the income year in which the change in ownership or affiliation occurred. The termination will be effective for the income year immediately succeeding the income year in which the change occurred. For a qualifying event that is not a change in ownership or affiliation, the request can be made at any time.

The request for termination of the election must be made under separate cover.

The taxpayer may withdraw its request any time prior to FTB's granting permission.

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### ***c. Time Period For FTB To Take Action<sup>13</sup>***

FTB has 90 days after the receipt of a request to terminate an election to either:

- (1) grant or deny the request, or
- (2) Request additional information needed to consider the request. After receipt of the information, FTB has 90 days to grant or deny the request.

#### ***1. Acceptance By Time***

If a taxpayer requests to terminate (without permission) because it has been acquired by a larger unaffiliated nonelecting entity, and FTB takes no action or requests no additional information, the taxpayer is deemed to have met the requirements for termination upon expiration of the 90 days.

#### ***2. Denial By Time***

If a taxpayer requests permission to terminate and FTB takes no action or requests no additional information, the request is deemed disallowed upon expiration of the 90 days. The taxpayer may grant FTB additional time to consider the request.

#### ***3. Information Which May Be Requested***

To consider the taxpayer's request, FTB may request books and records with respect to:

1. gains and losses regarding the sale or disposition of stock or assets of an affiliated bank or corporation which was included in a combined report prior to the water's-edge election,
2. earnings and profits of affiliated banks and corporations,
3. the nature of the event giving rise to the request,
4. the consequences of the event giving rise to the request, and
5. other relevant matters.

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### ***d. Conditions For Request To Terminate An Election<sup>14</sup>***

The conditions imposed in the case of an election terminated with the permission of the FTB, or in the case of an election disregarded by the FTB, do not apply in the case of an expired election or in the case of an election terminated at the discretion of the taxpayer.

A request for permission to terminate an election is subject to the following conditions.

#### ***1. Dividends***

If the taxpayer receives dividends during the remaining contract period from affiliates that had been excluded from the water's-edge combined report, such dividends will be considered to have been paid first out of the earnings and profits that had been excluded from the combined report for purposes of computing the intercompany dividend elimination. To the extent the dividends exceed such earnings and profits, they may be subject to the elimination.

Example 5:

D and its wholly owned subsidiary F were engaged in a unitary business for many years prior to D's water's-edge election in 1988, under which F was excluded from D's water-edge combined reports in 1988 and 1989. D terminates its election effective for 1990 through 1992. F had earnings and profits prior to 1988, during 1988 and 1989, and for the subsequent period. For purposes of determining the intercompany dividend elimination provided under RTC Section 25106, any dividends paid by F to D during 1990 through 1992 will be considered first to have been paid out of 1988 and 1989 earnings and profits. If the 1988 and 1989 earnings and profits are exhausted, dividends will then be considered paid out of the most recently accumulated earnings and profits.

#### ***2. Gains***

Gains on an intercompany distribution with respect to stock which is not a dividend or from the sale or other disposition of assets received during the

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remaining period of the contract from affiliated banks or corporations which were not included in the water's-edge combined report will not be deferred or eliminated.

### **3. Losses**

Losses from the sale or worthlessness of stock or from the sale or other disposition of assets of affiliated banks or corporations not included in the water's-edge combined report will be allowed only to the extent of dividend income or other gains recognized under items 1. or 2., unless the loss would have been recognized on a water's-edge return if the election had not been terminated.

### **4. Gains Or Losses On Water's-Edge Affiliates**

Gains or losses on the disposition of stock or assets of affiliated banks or corporations which were included in a combined report prior to the election and which were excluded from the water's-edge combined report will be included in income.

(A) Gains will be included in income in the first return filed after the termination of election.

Example 6:

D, its wholly owned subsidiary F, and F's wholly owned subsidiary F1 were engaged in a unitary business for many years prior to D's water's-edge election in 1988, under which F and F1 were excluded from D's water's-edge combined reports in 1988 and 1989. In 1988 F realized a substantial gain on the sale of its stock in F1 to an unrelated party. D terminates its election effective for 1990 through 1992. F's gain on sale of F1 will be recognized in the return filed for 1990.

(B) Losses will be included in income in the first return filed after permission is granted to the extent that gain is included under (A) above.

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Application of the conditions under CCR Section 25111-1(l) will result in an apparent mismatch of income recognition and apportionment factors in some instances. In the above example, for instance, gains realized in a water's-edge year will be subject to apportionment on the basis of the worldwide formula for the current year.

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### **e. *Re-Elections***

A new election may be made without regard to the fact that an election has been terminated or disregarded.

#### Example 7:

If a calendar-year taxpayer's election is effective for 1988 through 1992 but is terminated by the taxpayer on February 3, 1990, the taxpayer can file a new 5-year contract beginning January 1, 1991 or subsequent.

(Note: Under SB 671 (Stats 1993, Ch. 881), all contracts entered into prior to income years beginning on or after January 1, 1994 are automatically rescinded. See Section 3.1, Water's-Edge Manual for more information)

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### ***f. Disregarding The Election By FTB***

Prior to the enactment of new water's-edge legislation in 1993, FTB had the discretion of disregarding a water's-edge election. This discretionary authority was eliminated under SB 671 (Stats 1993, Ch. 881). Effective for income years beginning on or after January 1, 1994, FTB will no longer be able to disregard an election due to a taxpayer's failure to furnish information upon request or for any other reasons.

**Therefore, the following discussion is pertinent to elections entered into for income years beginning prior to January 1, 1994.**

The disregarding of the election is discretionary by FTB. It is on a year by year basis, but does not void the contract. The contract will continue in effect until its expiration date.

### ***1. Criteria For Disregarding The Election***

FTB may disregard a water's-edge election if any of the following occurs.

#### ***A. DOMESTIC DISCLOSURE SPREADSHEET (DDS) <sup>15</sup>***

A taxpayer willfully fails to substantially comply with the filing of a DDS. Omission or misstatement will be considered substantial noncompliance by the taxpayer if it interferes with the FTB's ability to determine:

1. the assignment of income or factors to the various jurisdictions in which the taxpayer or its affiliates are present and
2. the consistency of the reporting of income and factors to the various states.  
See Chapter 5, Water's-Edge Manual for a complete discussion of the DDS.

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### ***B. EVASION OF TAXES<sup>16</sup>***

FTB is not able to prevent the evasion of taxes after a reasonable adjustment of:

1. transfer prices,
2. royalty rates,
3. allocation of common expenses, and
4. similar adjustments.

FTB is required to prove the intent to evade. Evasion constitutes the purposefully dishonest or inaccurate reporting or assignment of an income item or expense.

A taxpayer may overcome an FTB determination of evasion by showing:

1. there was no omission,
2. the handling of an item was correct, or
3. the handling of the item is the subject of an unresolved disagreement.

(Disagreements regarding members of a unitary group or business/nonbusiness characterizations do not constitute an omission or incorrect treatment)

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### ***C. FAILURE TO PROVIDE CERTAIN INFORMATION UPON REQUEST<sup>17</sup>***

A taxpayer willfully fails, for the period during which the taxpayer's tax liability may be adjusted, to do any of the following:

1. Retain and make available documents and information involving the attribution of income between the U.S. and foreign jurisdictions. (As normally examined under IRC Sections 482, 861, 863, 902, 904 and Subpart F).
2. Retain and make available all documents and correspondence ordinarily available to a member of the water's-edge group which are submitted to or obtained from:
  - a. Internal Revenue Service,
  - b. foreign countries, their territories or possessions, and
  - c. competent authority (for audit procedures, see Chapter 18, Water's-Edge Manual) pertaining to ruling requests, rulings, settlement resolutions and competing claims involving jurisdictional assignment of income to the U.S. (to avoid double taxation).

The documents (with English translation, if available) include, but are not limited to ruling requests, rulings on reorganizations involving foreign branch incorporation, and the determination of foreign tax liability including reports issued by foreign tax administrators.

**NOTE:** Although our water's-edge regulation authorizes the use of information obtained from competent authority, it is doubtful the taxpayer could comply with a request for this information. The IRS will not disclose information obtained under competent authority to state agencies even under the exchange of information agreement between the FTB and the IRS. Typically, the income tax treaty provides that information exchanged shall be treated as secret and shall not be disclosed to any persons other than those concerned with the assessment, collection and enforcement of the federal taxes in question.

(3) Prepare and make available a list of each jurisdiction, including the District of Columbia, territories or possessions, and each foreign country, in which any related bank or corporation included in the spreadsheet has property, payroll or sales. The sales will be determined by whether or not the taxpayer is taxable in the destination jurisdiction.

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(4) Retain and make available any forms filed with the IRS to comply with IRC Sections 6038, 6038A and 6041.

As of January 1, 1989 these forms were:

- 1) Federal Form 851, Affiliations Schedule (includes voting stock information and changes in stock holdings during the year).
- 2) Federal Form 926, Return of stock or securities transferred to a foreign - organization under 1986 IRC Section 1491 (includes name & address of transferee, place of incorporation, type of entity: foreign corporation, foreign trust, or foreign partnership, description and amount of stock or securities transferred, date of transfer, complete statement of facts, copy of plan, fair market value of stock or securities transferred, and adjusted basis for determining gain).
- 3) Federal Form 5471, Information return with respect to a foreign corporation controlled by a U.S. "person" (U.S. resident or citizen, domestic partnership, corporation, estate or trust)
- 4) Federal Form 5472, Information return for every domestic or foreign corporation that is engaged in a trade or business in the U.S. and is controlled by a foreign person. Reporting is required if at any time during a tax year a foreign person owns at least 25% of the reporting corporation's stock either by value or voting power, and the corporation had reportable transaction(s) with a foreign affiliate, or had effectively connected income (ECI).

(5) Prepare and make available information similar to that required of foreign corporations under IRC Sections 6038, 6038A, and 6041 for each bank or corporation incorporated in the U.S. which has 50% or more of its stock is owned or controlled, directly or indirectly, by a bank or corporation in the water's-edge group. The consolidating workpapers used to prepare the consolidated financial statements for reporting to shareholders will normally meet this requirement.

(6) Prepare and make available all state tax returns, including the District of Columbia, filed by each bank or corporation in the water's-edge group.

(7) Comply with reasonable requests for information necessary to determine or verify:

- (a) net income
- (b) apportionment factors, or

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(c) geographic source of income under the IRC.

(8) Identify principal officers or employees having substantial knowledge and access to documents and records pertaining to:

- (a) pricing policies of goods and services
- (b) profit centers
- (c) cost centers
- (d) methods of allocating income and expense among the above centers, and
- (e) employee's titles and addresses.

The principal officers and employees would normally be the individuals whose depositions would be taken. (See Part 2 of Section 3.1(k), Water's-Edge Manual.)

### ***2. Notice To Disregard Notification***

FTB must give each taxpayer in the water's-edge group a 90-day advance written notice if it intends to disregard the water's-edge election signed by Assistant Executive Officer, Audit or the Chief Counsel. The taxpayer has the right to seek review of FTB's intended decision to disregard the water's-edge election in superior court.

The ninety-day period will not run while the review is pending.

### ***3. Time Period***

The FTB is authorized to disregard the election on a year by year basis. The 5-year contract period will still remain in effect for all years for which the election is not disregarded.

Note: For income years beginning on or after January 1, 1994, the FTB no longer has the ability to disregard the election.

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### **4. Retention Period**

The material described in Part 1C of Section 3.2(f), Water's-Edge Manual must be retained only for the time during which the taxpayer's tax liability may be adjusted, including:

- a) normal 4-year period,
- b) periods of appeal,
- c) pending lawsuits,
- d) waivers for assessing additional tax (state & federal), or
- e) periods for filing a claim for refund.<sup>18</sup>

### **5. Entities Affected By Disregarding The Election**

All members of the water's-edge group will have their elections disregarded if any taxpayer's actions, or lack of action, are found to be grounds for disregarding the election.

### **6. Criteria For Disregarding The Election<sup>19</sup>**

To have the election disregarded, the failure to meet the requirements must be:

- (1) willful, and
- (2) the document must be material. A document is not material if:
  - (a) other documents exist which supply the same information or the missing information can be derived or extrapolated from other documents,
  - (b) its existence or nonexistence would not be expected to change the tax liability of the water's-edge group by more than \$10,000, or
  - (c) a court of competent jurisdiction determines that the document is not material.

### **7. Conditions<sup>20</sup>**

The same conditions imposed when an election is terminated are also imposed when an election is disregarded. (See Section 3.2(d), Water's-Edge Manual. for the details of the "Conditions").

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### ***g. Summary***

In this section you have reviewed the items dealing with methods of terminating the contract, conditions under which the taxpayer can make a request of termination, and criteria and conditions under which the FTB can disregard an election. You have also been made aware of the changes in the law affecting the termination of contract for income years beginning on or after January 1, 1994. The new law effectively limited the conditions under which the taxpayer can request a termination. It also eliminated the FTB's ability to disregard an election.

In the next section you will review the penalties that can be assessed on a water's-edge taxpayer if the taxpayer fails to meet certain requirements.

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### Footnotes

1. CCR Section 25111(i)(1)(A)
2. CCR Section 25111(i)(1)(B)
3. CCR Section 25111(i)(1)(C)
4. CCR Section 25111-1(i)(1)(A)
5. CCR Section 25111(i)(2) or 25111-1(i)(2)
6. CCR Section 25111(i)(3)
7. CCR Section 25111(i)(4)
8. CCR Section 25111(i)(7)(A) or 25111-1(i)(5)(A)
9. CCR Section 25111(i)(5) or 25111-1(i)(3)
10. Barclays Bank PLC vs. the FTB, 512 US 298, 129 L Ed 2d 244, 114 S Ct 2268)
11. CCR Section 25111(i)(6)(A) or 25111-1(i)(4)(A)
12. CCR Section 25111(i)(7) or 25111-1(i)(5)
13. CCR Section 25111(i)(7)(D) or 25111-1(i)(5)(D)
14. CCR Section 25111(m) or 25111-1(j)
15. CCR Section 25111(j)(1)(A)
16. CCR Section 25111(j)(1)(B)
17. CCR Section 25111(j)(1)(C)
18. CCR Section 25111(k)
19. CCR Section 25111(l)
20. CCR Section 25111(m)

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### Section 3.3 Water's-Edge Election And Contract - Penalties

#### ***Contents:***

- a. INTRODUCTION
- b. §25112 PENALTIES FOR FAILURE TO SUPPLY INFORMATION OR DOCUMENTS
- c. FORMAL DOCUMENT REQUEST
- d. ADDITIONAL PROVISIONS
- e. SUMMARY

#### ***References:***

Revenue & Taxation Code Section 25112  
California Code of Regulation Section 25112

#### ***Training Objectives:***

The information contained in this section will allow the reader to:

- 1. determine the penalties for failure to provide certain information;
- 2. circumstances under which the penalties can be assessed

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### **a. Introduction**

The auditor may assess a penalty under Revenue and Taxation Code (RTC ) Section 25112 when the taxpayer has failed to furnish information as requested by the auditor. Procedures set forth in the regulation must be carefully followed before the penalties can be assessed. The penalty can be assessed 60 days after a written request for information is made to the taxpayer. The penalty amount is \$1,000 for each income year. Additional penalties of \$1,000 per a 30-day period, up to \$24,000, can be assessed per taxpayer for each income year if the failure to furnish continues. The total amount of penalties that can be assessed per taxpayer is \$25,000.

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### ***b. Penalties For Failure To Supply Information Or Documents***

#### ***1. Basis For Assessing Penalty***

Before the penalty can be assessed under CCR Section 25112(a)(3), the taxpayer must be informed in a written request for information that it is subject to the penalty. The auditor must explain that the penalty is being assessed under RTC Section 25112 for either failure to provide information requested or because the taxpayer's prior responses have been unsatisfactory. The penalty cannot be assessed unless the taxpayer has received advance notification.<sup>1</sup>

The auditor may make a single request for information that may apply to several income years (including short periods). It is important to list each taxpayer on the written notice because these penalties are assessed on a "per taxpayer" basis (i.e. list each taxpayer included in a combined report).<sup>2</sup>

The penalty is assessed for the failure to furnish information, not for each failure to furnish information nor for each item of information or each document not furnished. The failure must also be of a substantial or material nature as shown by:

- the potential significance of the item(s), or
- the quantity of the item(s) not supplied.<sup>3</sup>

#### ***2. 60 Days Written Notice***

The 60-day written request should not be the first request (i.e. Information Document Requests (IDR'S), letters, etc. should already have been issued requesting the information either specifically or generally). The notice will include a list of prior requests and specify the basis (if any) on which prior responses were considered unsatisfactory.

- The request for information must include item(s) described in RTC Section 25112(b). (See also Part 1 of Section 3.3(d), Water's-Edge Manual).

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- The written request will advise each taxpayer that it is subject to the \$1,000 penalty for failure to furnish information.
  - The 60-day written notice will be issued by an FTB auditor or attorney.
  - The notice will include a list of prior requests and specify the basis (if any) on which prior responses were considered unsatisfactory.
  - The taxpayer has 60 days from the date of mailing to respond.
  - The 60-day period will be suspended during the time the question of reasonable cause is under review. (See Item 5-"Reasonable Cause" below.)

### **3. \$1,000 Penalty**

The \$1,000 per taxpayer failure to furnish penalty can be issued any time after the expiration of the 60-day period. The audit need not be completed.

### **4. 90-Days Written Notice**

If the failure to furnish information continues after the 60-day period expires, a 90-day written notice will be sent to each taxpayer informing it of the failure and of the fact that an additional penalty of \$1,000 per 30-day period (or fraction thereof) may be assessed. The additional penalty may not exceed \$24,000. A total penalty of \$25,000 may be assessed for each taxpayer for each income year.<sup>4</sup>

- The 90-day notice will be issued by a bureau director or a supervising counsel.
- The notice will include a list of prior requests and specify the basis on which prior responses were considered unsatisfactory.
- The 90-day notice will advise each taxpayer that the initial penalty of \$1,000 will be assessed.
- The 90-day notice will advise each taxpayer that an additional penalty of \$1,000 per 30-day period (or fraction thereof) may be assessed for further failure to furnish information. The additional penalty is not to exceed \$24,000 for each income year.
- The taxpayer has 90 days from the date the notice is mailed to respond.
- The 90-day period will be suspended during the time the question of reasonable cause is under review.

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### **5. Reasonable Cause For 60-Day And 90-Day Notices**

The penalties under RTC Section 25112(a) will not apply if the taxpayer establishes that the failure to provide information is due to reasonable cause. The 60-day or 90-day periods do not begin until the issue of reasonable cause no longer exists.<sup>5</sup> The periods will be suspended during the time the question of reasonable cause is under review.

#### **A. SHOWING REASONABLE CAUSE**

To show that reasonable cause existed, the taxpayer must provide a written statement showing all facts substantiating the reasonable cause and include a declaration that it is made under the penalties of perjury. The taxpayer must file this statement with the bureau director or supervising counsel who signed the 90-day written notice.

The bureau director or supervising counsel will determine whether the failure to furnish information was due to reasonable cause. Notification of the determination will be given to the taxpayer.

#### **B DESTRUCTION OR RETENTION OF INFORMATION.**

Destruction of or failure to retain documents or information is reasonable cause if it occurred in the normal course of business. However, failure to maintain documents or information required under the water's-edge provisions of the RTC is not reasonable cause.<sup>6</sup>

Reasonable cause for a period not to exceed 90 days exists if a document or information is located in a foreign country.

### **6. Assessing Penalties**

The initial penalty is assessed in the same manner as assessing the additional tax. The penalty can be assessed immediately without having to wait until the audit is completed.

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The additional penalty is also assessed in the same way as assessing the tax except that the notice need not be issued until the full penalty has accrued. The taxpayer pursuing its protest rights on the initial \$1,000 penalty assessment does not prevent the accrual and assessment of the additional \$1,000 per month penalties.

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### ***c. Formal Document Request<sup>7</sup>***

A formal document request is defined under RTC Section 25112(g) as any request for the production of documentation which is mailed by registered or certified mail to the taxpayer at its last known address and is made after the normal request procedures have failed to produce the requested documentation. It can be issued during any stage although it should be made after normal written request procedures have been unsuccessful. The penalties provided for by RTC Sections 25112(a) & (b) do not have to be imposed for the requirement of a normal request procedure to be met.

#### ***1. Requirements For Request***

##### ***A. MAILING***

The formal document request must be mailed to the last known address and sent by registered or certified mail to the taxpayer (or taxpayers).

##### ***B. REQUEST PROCEDURE***

The request must include:

1. Time and place for the production of the documentation.
2. A statement of the reason the documentation previously provided (if any) was not sufficient.
3. A description of the documentation being requested.
4. Description of the consequences (penalties, exclusion of records, and/or disregard) to the taxpayer for failure to produce the requested documentation.
5. The statement must be signed by the Assistant Executive Officer, Audit or the Chief Counsel.
6. The request may also include a requirement that an English translation of any foreign documents be supplied if it exists.

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### **2. Reasonable Cause For Failure To Produce**

A penalty will not apply if the taxpayer establishes that the failure to provide information is due to reasonable cause. If delays for failure to furnish information are due to reasonable cause, the 90-day period will begin on the last day that reasonable cause existed.

A court will determine if reasonable cause existed. A court will consider:

A) Is the request reasonable in scope?

Examples:

(1) The reasonableness of a demand for the production of the originals of foreign documents rather than copies may be resolved in court. If the foreign country makes it impossible to remove the original documents requested not because of secrecy laws but, for example, because of its tax laws or laws as to the rights of creditors, true copies may be sufficient.

(2) A reasonable delay may be due to translation of documents into English per FTB's request.

(3) Minority Status - facts and circumstances will dictate whether a minority interest in an entity that has custody of a document is reasonable cause.

B) Are requested documents or copies available within the U.S.?

Example:

The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause unless the court finds it to be.<sup>8</sup>

C) Is the place of production within the U.S. reasonable?

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### **3. Motion To Quash**

A judicial proceeding to quash the formal document request may be commenced within 90 days of the mailing of the request.

### **4. Grounds To Quash**

#### **A. GROUNDS**

1. A contention that all parts of the requested documentation are irrelevant to the issue.
2. The place of production is unreasonable.
3. Reasonable cause exists for failure to produce.
4. Reasonable cause exists for delay in production.
5. Reasonableness of requesting original documents rather than copies when, for example, foreign laws prevent their removal.

#### **B. BURDEN OF PROOF**

FTB has the burden of proving:

- the relevance and materiality of the requested records,
- that the audit is being conducted for a legitimate purpose,
- that the information sought is not already within its possession, and
- that the administrative steps required have been followed.

#### **C. TIME TO COMPLY**

The taxpayer has 90 days from the day of mailing the formal document request to comply.

An extension of the 90-day period may be made by the FTB or a court having jurisdiction.

Any action to quash results in the suspension of the 90-day period. The running of any period of limitations for issuing notices of proposed deficiency assessment

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under RTC Sections 19057 to 19064 will be suspended for the period during which the proceedings to quash and appeals are pending.

### ***D. MOTION TO PROHIBIT INTRODUCTION OF DOCUMENTS***

After the expiration of the 90-day period, FTB may bring a motion to prohibit introduction of the requested documents in any subsequent judicial or administrative proceeding.<sup>9</sup>

The fact that a document is not required to be maintained, has not been maintained, or has been destroyed will not prevent a court from issuing an order providing for the exclusion of a later discovered copy of the document.

This "exclusion" rule is based on the exclusion of foreign records provision found in IRC Section 982. It was applied for the first time in Flying Tigers Oil Co., Inc. v. Comr. After sending numerous IDRs with no response by the taxpayer, the IRS followed with a summons containing a request for the original IDR information and a warning that foreign-based documents could be excluded from subsequent litigation. The IRS issued a deficiency notice based on information available. The Tax Court refused to allow the taxpayer to introduce any foreign-based documents. It also excluded the taxpayer's domestic documentation which it found was either based on or prepared in reliance on such foreign documents.

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### **d. Additional Provisions**

For income years beginning on or after January 1, 1994, a taxpayer will be subject to the penalties under RTC Section 25112 if it **willfully** fails to retain the materials described below. The information must be maintained for the period of time during which the taxpayer's tax liability may be adjusted, including for the period of time during which the appeal is pending before the Board of Equalization (BOE) or a lawsuit is pending in the courts.<sup>10</sup>

#### **1. Information That Must Be Retained**

The taxpayer will be subject to the penalties if it willfully fails to do the following:

- A. Retain and make available documents and information involving the attribution of income between the U.S. and foreign jurisdictions. (As normally examined under IRC Sections, 482, 861, 863, 902, 904 and Subpart F).
- B. Identify principal officers or employees who have substantial knowledge of and access to information on the allocation of cost and profits and prices of goods and services.
- C. Retain and make available documents and correspondence submitted to or obtained from the IRS, tax agencies of foreign countries and competent authority (for audit procedures-See Chapter 18, Water's-Edge Manual).

The documents (with English translation if available) include but are not limited to:

- (1) ruling requests; rulings on reorganizations involving foreign branch incorporation; and
- (2) the determination of foreign tax liability including reports issues by foreign tax administrators.

D. Retain and make available any forms filed with the IRS to comply with IRC sections 6038, 6038A, 6038B, 6038C, and 6041. As of January 1, 1995, these forms are IRS Forms 851, 926, 5471 and Worksheets A, B and Schedule M1, and 5472.

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E. Prepare and make available information similar to that which is required of foreign corporations under IRC Sections 6038, 6038A, 6038B, 6038C and 6041 for each bank or corporation incorporated in the U.S. which has 50% or more of its stock owned or controlled, directly or indirectly, by a bank or corporation in the water's-edge group.

The consolidating workpapers used to prepare the consolidated financial statements for reporting to shareholders will normally meet this requirement.

F. Prepare and make available all state tax returns filed by each bank or corporation in the water's-edge group.

G. Comply with reasonable requests for information necessary to determine or verify net income and apportionment factors, or geographic source of income under the IRC.

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### e. *Summary*

In this section you have reviewed the circumstances in which the failure to furnish information penalties under RTC Section 25112 can be assessed. You have also reviewed the requirements that must be met and the processes that must be followed

Before the penalties can be issued. Key elements of the failure to furnish penalty provisions are as follows.

1. The initial penalty is \$1,000 per taxpayer per year.
2. The additional penalty is \$1,000 per 30-day period up to \$24,000.
3. The taxpayer must be informed in a written notice that it is subject to the penalty. An FTB auditor or attorney will issue the 60-day written notice. A bureau director or supervising counsel will issue the 90-day notice.
4. The taxpayer must show reasonable cause to avoid the penalties.
5. CCR Section 25112 was amended to include the information retention provisions originally found under CCR Section 25111, and to include the \$1,000 penalty for failure to comply. These provisions, effective for income years beginning on or after January 1, 1994, clarify the types of information that must be retained during the period statute of limitations is open and during which an appeal is pending before the BOE and the courts. For income years beginning prior to 1994, the information retention provisions are found in CCR Section 25111(l) (formerly Section 25111(k)).

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

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### **Footnotes**

1. CCR Section 25112(a)(3)
2. CCR Section 25112(2)(B)
3. CCR Section 25111(a)(2)(C)
4. CCR Section 25112(a)(4)
5. CCR Section 25112(a)(5)(B)
6. CCR Section 25112(a)(5)(D)
7. CCR Section 25112(g)
8. CCR Section 25112(f)
9. CCR Section 25112(b)(5)(B)
10. CCR Section 25112(d)

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated**