

DISCUSSION TOPICS

Franchise Tax Board Interested Parties Meeting
Regulation Section 25111: Water's-Edge Election
Proposed Regulation Section 25113: Water's-Edge Election
March 25, 2008

1. Overview and History of Regulation Section 25111 and Revenue and Taxation Code (RTC) Section 25113.

In 1988, the California Legislature adopted section 25110, et seq., which allowed California taxpayers that were members of a unitary group to "elect to account for and determine their income derived from California sources by considering only the income and apportionment factors" of certain affiliated corporations, which are generally only the domestic members of the unitary group, which is called the "water's-edge" method.

Originally, taxpayers that wanted to utilize the water's-edge method of combined reporting were required to enter into a contract with the Franchise Tax Board for a seven-year (84-month) period. The requirements for satisfying the terms of the contract were contained in section 25111 and the regulations promulgated thereunder. For taxable years beginning on or after January 1, 2003, the provisions for making a water's-edge election were substantially changed when section 25113 was enacted and RTC section 25111 was amended. RTC section 25113 replaced the contract provided for in RTC section 25111 with a statutory election, which is also to be made for a seven-year (84-month) period.

To date, there have been no regulations promulgated with respect to section 25113. However, the Franchise Tax Board issued [FTB Notice 2004-2](#) to address transition issues between the two statutes.

A. Regulation Section 25111:

Regulation section 25111 currently provides definitions or explanations of several key concepts:

- Substantial Performance -- The election shall be considered valid "so long as there has been substantial performance of the requirements for entering into the contract," with "substantial performance" being defined as "'objective evidence' to support the conclusion that an election was intended." The regulation then continues by providing a nonexclusive list of what constitutes "objective evidence." (Regulation § 25111(a)(2)(A).)
- Water's-Edge Group -- The water's-edge group means "all banks, corporations or other entities whose income and apportionment factors are considered pursuant to Section 25110 of the Revenue and Taxation Code in computing the income of the individual taxpayer for the current income year

which is derived from attributable to sources within this state." (Regulation § 25111(b)(1).)

- Original Return – The original return is "the last return filed on or before the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated." The regulation then continues by providing further explanation of how to treat "timely filings which only supplement a previously filed return." (Regulation § 25111(e)(1).)
- Effect of Different Fiscal Years -- In the case of taxpayers with different fiscal years, "each member of the water's-edge group must make the election on its timely filed original return for the taxable year for which the election is being made." The regulation continues by providing that "each taxpayer in the group must compute its tax on a worldwide basis for that portion of the year between the beginning of its taxable year and the beginning of the taxable year of the last member of the group to make the election, and on a water's-edge basis for the remainder of the taxable year." (Regulation § 25111(g).)

B. Revenue and Taxation Code Section 25113:

Section 25113 provides new rules for taxpayers to use in terminating their water's-edge election. For example:

- The taxpayer has the option to terminate its water's-edge election after the expiration of the initial seven-year (84-month) period. This termination does not require Franchise Tax Board consent. (Regulation § 25113(c)(9).)
- An electing taxpayer may request Franchise Tax Board consent to terminate its water's-edge election for good cause prior to the expiration of the seven-year (84-month) period. Good cause for these purposes has the same meaning as specified in Treasury Regulation § 1.1502-75(c). (Regulation §25113(c)(10)(A).)
- If a taxpayer terminates its water's-edge election and returns to filing on a worldwide basis, then the taxpayer must file on a worldwide basis for at least seven taxable years before making another water's-edge election. However, the Franchise Tax Board may waive the application of this rule for good cause. (Regulation § 25113(c)(11).)

C. Coordination of Revenue and Taxation Code sections 25111 and 25113

Sections 25111 and 25113 both indicate that taxpayers that have a valid election for taxable years beginning before January 1, 2003 will continue to file on a water's-edge basis and will be deemed to have elected under the new rules for taxable years beginning on or after January 1, 2003. However, the election start date under the new rules will continue to be the start date as originally elected under the old rules.

D. Franchise Tax Board Notice 2004-2, May 3, 2004:

The Franchise Tax Board issued this notice to provide guidance on the provisions for making a water's-edge election under section 25113, and the interaction with the rules under section 25111. The examples that are provided within this Notice relate to many of the questions taxpayers raised to staff after section 25113 was enacted.

2. Discussion Focus

The department anticipates having an open discussion to address concerns that may be present, together with possible approaches to resolve potential problems.

Staff believes that the following core principles provide an objective basis to guide the discussion and to evaluate proposed solutions:

- A. Equity: Are all taxpayers being treated similarly?
- B. Administrability: Is the rule clear and simple? Can taxpayers and the department apply the new rule?
- C. Elimination of potential disputes: Does the new rule raise concerns that could lead to new disputes?
- D. Recordkeeping: Does the new rule use existing records as much as possible to minimize taxpayer recordkeeping burdens?

Given this basic framework, it appears to staff that amendments should be made to the regulations adopted pursuant to section 25111 and a new regulation under section 25113 should be adopted. These may include:

- A. Amending Regulation section 25111 to indicate that a valid election made under that section will be deemed to have been made under the new rules of section 25113 for taxable years beginning on or after January 1, 2003;
- B. Drafting the new Regulation section 25113 to include the explanation of the terms substantial performance, water's-edge group, original return, and effect of different fiscal years from Regulation section 25111;
- C. Incorporating any other relevant portions of Regulation section 25111 into the new Regulation section 25113;
- D. Defining the following terms in the new Regulation section 25113:
 - a. "timely filed";
 - b. "commencement date";
 - c. "net book value";
- E. Addressing in new Regulation section 25113:
 - a. rules for an election ending in mid year;

- b. at what point the total business assets of the corporations should be evaluated for purposes of determining the prevailing method of filing;
 - c. rules if the electing and non-electing corporations are not instantly unitary;
 - d. the procedures that the taxpayer must fulfill for filing requirements for terminations and re-elections;
 - e. the effective dates of the terminations and re-elections;
- F. Incorporating examples and explanations from Franchise Tax Board Notice 2004-2;
- G. Addressing other problem areas that participants identify during the interested parties process.

Staff would like input on these issues as well as any other issues participants may have noted in the regulation. You may contact Karen Smith, the lead legal staff person for Regulation sections 25111 and 25113, at Karen.Smith@ftb.ca.gov.

Note: In addition, the department is currently reviewing Regulation section 25114, relating to Presumptions Arising from Federal Audits for water's-edge taxpayers, as well. An interested parties meeting on Regulation section 25114 is scheduled for March 25, 2008 at 11:30 a.m. at the Franchise Tax Board, Golden State Room A, 9646 Butterfield Way, Sacramento, CA 95827 (Use North Lobby Entrance). A notice of that meeting and a list of discussion topics can be found at www.ftb.ca.gov. Highlight "Public Meetings" under the "News and Events" heading on the home page and click on "Interested Parties Meetings." You may contact Craig Swieso, the lead legal staff person for Regulation section 25114, at Craig.Swieso@ftb.ca.gov.