

Executive Summary

In 1988, the California Legislature adopted Revenue and Taxation Code 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. This election 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 an 84-month period. The requirements for satisfying the terms of the contract were contained in Revenue and Taxation Code 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 Revenue and Taxation Code section 25113 was enacted and Revenue and Taxation Code section 25111 was amended. Revenue and Taxation Code section 25113 replaced the contract provided for in Revenue and Taxation Code section 25111 with a statutory election, which is also to be made for an 84-month period.

To date, there have been no regulations promulgated with respect to Revenue and Taxation Code section 25113. However, the Franchise Tax Board issued FTB Notice 2004-2 to address transition issues between the two statutes. The Franchise Tax Board issued this notice to provide guidance on the provisions for making a water's-edge election under Revenue and Taxation Code section 25113, and the interaction with the rules under Revenue and Taxation Code section 25111. The examples that are provided within this Notice relate to many of the questions taxpayers raised to staff after Revenue and Taxation Code section 25113 was enacted.

Revenue and Taxation Code 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.

The proposed regulation is prospective in its application to taxable years beginning on or after January 1, 2008.

Request for Permission to Proceed with Formal Regulation Process on Amendments to California Code of Regulations, Title 18, Section 25111, and Proposed Regulation Section 25113, Relating to Water's-Edge Elections

For California purposes, the water's-edge method of combined reporting has always been elective. Originally, taxpayers that wanted to utilize the water's-edge method of combined reporting had to enter into a contract with the FTB. The requirements for satisfying the terms of the contract evidencing the election are contained at Revenue and Taxation Code section 25111 and California Code of Regulations, title 18, section 25111.

Revenue and Taxation Code section 25113 (added by Stats. 2003, ch. 633, § 10) replaced the contract with a statutory election that continues in effect for a minimum of 84 months. Taxpayers that made a water's-edge election prior to January 1, 2003, continue to file on a water's-edge basis and are deemed to have elected under the new statute. However, the original commencement (start) date, as elected under Revenue and Taxation Code section 25111, remained in effect.

To date, there have been no regulations promulgated with respect to Revenue and Taxation Code section 25113. However, staff did issue [FTB Notice 2004-2](#) on May 3, 2004 to provide guidance to taxpayers on the implementation of Revenue and Taxation Code section 25113 and its interface with Revenue and Taxation Code section 25111. (A copy of that Notice is attached.) Staff's proposed regulation incorporates some of the provisions of that Notice as well as clarifies provisions of Revenue and Taxation Code section 25113. Staff also proposes to amend California Code of Regulations, title 18, section 25111, to indicate the effect of an election made under that section prior to the date that Revenue and Taxation Code section 25113 was enacted.

Because staff wished to have industry input, an interested parties meeting was held earlier this year to discuss how California Code of Regulations, title 18, section 25111, should be amended and to discuss the contents of proposed regulation section 25113. In general, the interested parties agreed that utilizing the format and some of the language of California Code of Regulations, title 18, section 25111, in drafting the language for proposed regulation section 25113 would be appropriate, as would utilizing some of the examples from FTB Notice 2004-2. Also, the interested parties agreed that only a minor change to California Code of Regulations, title 18, section 25111, was needed to reflect the changes made to Revenue and Taxation Code section 25111, concerning the commencement date of an election made prior to January 1, 2003.

No consensus was reached, but input was provided at the interested parties meeting and in correspondence received thereafter concerning two issues in particular. Those issues involved the date when business assets should be valued and what would be an appropriate time frame during which taxpayers could request permission to terminate an election. Staff has attempted to reflect the concerns of the interested parties in the draft language.

The proposed regulation is prospective in its application to taxable years beginning on or after January 1, 2008.

New Language shown in underline

Section 25111 is amended to read:

§ 25111. Water's-Edge Election.

(a) General. This regulation shall be applicable to election contracts entered into for taxable years beginning on or after January 1, 1994 and before January 1, 2003. To the extent that a taxpayer would have been required to file on a water's-edge basis in its first taxable year beginning on or after January 1, 2003, pursuant to a water's-edge election made in a prior year under Revenue and Taxation Code section 25111 and this regulation, the terms of this regulation no longer apply and that election shall be deemed to have been made under the terms of Revenue and Taxation Code section 25113. However, the commencement date of the election made in a prior year under Revenue and Taxation Code section 25111 and this regulation shall continue to be treated as the commencement date of the water's-edge election period for purposes of applying the provisions of Revenue and Taxation Code section 25113.

(1) The election. In order to make the water's-edge election permitted by Revenue and Taxation Code section 25110, a taxpayer must enter into a contract with the Franchise Tax Board. The contract must be for an 84-month period.

(2) Validity of Election. The election contract shall be considered valid so long as there has been substantial performance of the requirements for entering into the contract.

(A) For purposes of this subsection "substantial performance" means that although there may have been noncompliance with one or more procedural or statutory requirements for making the election, the tax was computed consistent with a water's-edge election and there exists additional objective evidence to support the conclusion that an election was intended.

1. For purposes of this section objective evidence includes, but is not limited to:

a. One or more of the following substantially completed forms (or their successors) were attached to the original return: 100-WE, 1115, 1116, 2411, 2416, 2424, or 2426, or

b. Form 1117 request to terminate an election which sets forth the expiration date of the contract from which the first year of intended

election can be determined, was filed before January 1, 1997; or

c. A statement was attached to the original return indicating a water's-edge election was being made.

2. There may exist other evidence sufficient to support the conclusion that an election was intended, which may include checking a water's-edge box on the return.

(B) In the absence of a common parent election, whether or not there has been substantial performance of the procedural and statutory requirements for entering into a contract shall be determined with reference to the actions of the entire water's-edge group, as defined in subsection (b)(1). Substantial performance by every member of the water's-edge group shall constitute substantial performance by the entire water's-edge group. It is not necessary for every member of the group to substantially perform for an election to be valid.

(3) Termination.

(A) A taxpayer may request and the Franchise Tax Board shall terminate the election if the taxpayer is acquired by a larger nonelecting entity as described in subsection (i)(2)(A) of this regulation. The Franchise Tax Board may also in its discretion grant the taxpayer permission to terminate the election in other circumstances.

(B) For taxable years ending on or before January 31, 1997, if the water's-edge election of a corporation is affected by the amendments to this regulation effective October 31, 1998,

1. if prior to the effective date of such amendments the corporation was acquired by a non-electing, non-affiliated entity, and

2. if subsequent to the acquisition but prior to the effective date of such amendments, the acquired taxpayer filed its returns as if no water's-edge election were in place, the acquired taxpayer shall be deemed to have requested and been granted a termination of the water's-edge election as of the time of acquisition. Any termination resulting from the operation of this subsection (a)(3)(B) shall not be subject to the provisions of subsection (j) of this regulation.

(4) Ability to re-elect. The fact that a taxpayer has filed a notice of nonrenewal, or has terminated an election, or has been granted a change of election, shall not affect its ability to make an election subsequently.

(b) Definitions.

(1) Water's-edge group. Water's-edge group for purposes of Revenue and Taxation Code section 25111 means all corporations or other entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110 in computing the income of the individual taxpayer for the current taxable year which is derived from or attributable to sources within this state.

(2) Anniversary date. The anniversary date of the contract shall be the later of the original due date of the return or the due date of the return as extended. The anniversary date is established at the time the taxpayer enters into the contract and is on the same date for each subsequent year the election is in effect.

(c) Election by common parent. Election by the common parent of a controlled group which files a consolidated federal return pursuant to Internal Revenue Code section 1501, or the common parent wherever domiciled or organized, shall constitute an election by all members of the commonly controlled group which are part of the water's-edge group, notwithstanding any prior or subsequent filing by any member of the commonly controlled water's-edge group for the taxable year for which the election is being made (taking into account the provisions of subsection (g) of this regulation). The common parent may effect a common parent election whether or not the common parent is a taxpayer obligated to file a return in this state or will be a member of the water's-edge group for which the election is made. In such cases, the common parent election must be made on an original return filed by a member of the water's-edge group required to file under this part. Effective for taxable years beginning on or after January 1, 1995, a commonly controlled group is defined by Revenue and Taxation Code section 25105.

EXAMPLE: 1. Parent, a calendar year taxpayer, makes a common parent water's-edge election and includes Subsidiary A, also a calendar year taxpayer, as a member of the water's-edge group.

A. Parent, a California taxpayer, files a single group return on a combined basis for all members of the water's-edge group and includes the income and apportionment factors (both numerators and denominators) of A. A files a separate return and does not elect. A is deemed to have elected.

B. Parent, a California taxpayer, files its own return on a combined basis including the income and factors of A (denominators only) and other members of the water's-edge group. A files a separate return and does not elect. A is deemed to have elected.

C. Parent is not a California taxpayer but makes a common parent election which B, a member of the water's-edge group, includes with its return filed on a water's-edge basis. A files a separate return and does not elect. A is deemed to have elected.

D. Parent is not a California taxpayer. No common parent election has been filed by any California taxpayer which is a member of the water's-edge group prior to the due date (taking extensions into account) for filing a return. After the due date (taking extensions into account), a delinquent original California return is filed with a common parent election by a member of a commonly controlled group. Unless the corporation filing the return has a requirement to file a return with California and is a member of the water's-edge group, there is no valid election.

EXAMPLE 2. Same as 1 but Parent and A have different fiscal years. P's taxable year ends 3/31 and A's taxable year ends 12/31. P files its 3/31/98 taxable year return on 1/15/99 on a combined basis which includes A. A files its 12/31/98 return on 10/15/99 on a separate company basis and does not elect. A is deemed to have elected. A's and P's election begins 1/1/98 in accordance with the provisions of subsection (g) of this regulation.

(d) Election, those affected.

(1) In general. The contract, to be effective, must be entered into by all corporations required to file under this part which are part of the water's-edge group, or by the common parent electing in accordance with the provisions of subsection (c) of this regulation. A taxpayer or group of affiliated taxpayers, which is engaged in more than one unitary business, may make a water's-edge election with respect to one or more of the businesses, but it need not elect for all of its businesses.

EXAMPLE: Taxpayers A and B are members of an affiliated group which includes C, D, E and F, all incorporated in the United States, and G, H and I, all incorporated outside of the United States. G, H and I have no factors in the United States, are not eligible to be included in a federal consolidated return, and have no Subpart F income. A, C, D and G are engaged in one unitary business. B, E, F, H and I are engaged in a separate unitary business. Either A or B may elect to file on a water's-edge basis pursuant to Revenue and Taxation Code section 25110. It is not necessary for both A and B to make a water's-edge election.

(2) Changes in affiliation. Except as provided in Revenue and Taxation Code section 25111, subdivision (b), taxpayers will be bound by any valid contract they entered into, or are deemed to have entered into, for the entire term of the contract. Taxpayer will, for example, be bound by the election in the following situations:

(A) Subsequently taxable. A member of the water's-edge group which becomes subject to tax under this part subsequent to the election, or, subsequent to the election, is determined to have been subject to tax at the time of the election, shall be deemed to have elected.

(B) Subsequently determined to be a member of the water's-edge group. Except as provided in of Revenue and Taxation Code section 25111, subdivision (b), if an affiliated corporation which is a non-electing taxpayer is subsequently proved to be a member of the water's-edge group pursuant to a Franchise Tax Board audit determination, such affiliate shall be deemed to have made a water's-edge election effective as of the date of the election of the other members of the water's-edge group. A Franchise Tax Board audit determination shall be evidenced by the issuance of a notice of deficiency proposed to be assessed or a notice of tax change.

(C) Subsequently becoming a member of the water's-edge group. Except as provided in of Revenue and Taxation Code section 25111, subdivision (b), a corporation subject to tax under this part which becomes a member of an electing water's-edge group subsequent to an election having been made by the group shall be deemed to have elected, and shall be bound by, the election and the contract made by the group for the remaining term of the contract. In the event that such corporation becomes a member of an electing water's-edge group for part of a year, then such corporation shall be considered a water's-edge electing taxpayer only with respect to such part of a year and not for the entire year.

EXAMPLE: A elects to file its returns in accordance with Revenue and Taxation Code section 25110 for a period of 84 months beginning in 1994 and ending in 2000. B makes no election under Revenue and Taxation Code section 25110 and files its returns for years through 1997 pursuant to Revenue and Taxation Code section 25101. In 1998 A and B become engaged in a unitary business. For 1998 through 2000, B is deemed to have elected and shall be subject to the terms of A's election and contract.

(D) Reorganizations. Subject to the provisions of Revenue and Taxation Code section 25111, subdivision (b), a reorganization under sections of the Revenue and Taxation Code and Internal Revenue Code section 368 involving a water's-edge taxpayer will not cause a termination of the water's-edge election. In the case of an acquisitive reorganization, the water's-edge election is a tax attribute which will carry over to the acquiring corporation. Thus, for example, if a water's-edge taxpayer which is a party to a reorganization merges or liquidates into an acquiring corporation as a result of the reorganization, the water's-edge election will carry over and be binding upon the acquiring corporation. Each member of the acquiring group which is subject to tax under this part and which is, or subsequently becomes, unitary with the acquired water's-edge taxpayer or its successor shall be deemed to have elected and shall be bound by the acquired corporation's water's-edge election.

The carryover water's-edge election will not be binding on nonunitary activities of the acquiring corporation or its affiliates.

EXAMPLE: Corporation A, a calendar year taxpayer, elects to file its returns on a water's-edge basis for a period of 84 months beginning January 1, 1994. Corporation B, an unrelated calendar year taxpayer, has never made an election and files its California returns on a worldwide basis. On July 1, 1996, Corporation A is acquired by Corporation C, a unitary affiliate of Corporation B, in a statutory merger qualifying under Internal Revenue Code section 368(a)(1)(A). Corporation C was not itself a California taxpayer prior to acquiring Corporation A. The merged operations of former Corporation A became unitary with the pre-merger operations of surviving Corporation C, and therefore with Corporation B, effective January 1, 1997.

Corporation A's water's-edge election carries over to Corporation C. For the period July 1, 1996, through December 31, 1996, Corporation C will compute the taxable income attributable to the nonunitary merged activities of Corporation A on a water's-edge basis. Corporation B will compute its taxable income on a worldwide basis, including the pre-merger operations of surviving Corporation C, but not including the operations of Corporation C which were acquired by merger with Corporation A. (Since Corporation C was not a taxpayer prior to acquiring Corporation A, it does not have a California filing requirement with respect to the business operated by Corporation C before the merger.) Effective January 1, 1997, both Corporation B and Corporation C will be required to compute their income on a water's-edge basis.

(E) Liquidations. A water's-edge election is a tax attribute which will carry over and be binding upon the distributee(s) of property in a complete

liquidation of a water's-edge taxpayer to which Internal Revenue Code section 332 applies. However, for purposes of this subsection, the definition of "owner of stock" as set forth in of Internal Revenue Code section 332(b)(1) shall not apply. Rather, the owner of stock shall be defined as any corporation which is related to the liquidating corporation because of either of the following:

1. It owns directly or indirectly more than 50 percent of the voting stock of the liquidating corporation.
2. More than 50 percent of voting stock of both it and the liquidating corporation is owned or controlled directly or indirectly by any bank or person (as defined in Internal Revenue Code section 7701(a)(1)).

The carryover water's-edge election will not be binding on nonunitary activities of the distributee corporation(s) or its affiliates.

(F) Transfer to controlled entity. If an electing taxpayer transfers property to a corporation in a transaction to which Internal Revenue Code section 351 applies, the water's-edge election will be binding upon the transferee of the property. The carryover water's-edge election will not affect nonunitary activities of the transferee corporation.

(G) Subsequently disaffiliated. Except as provided in Revenue and Taxation Code section 25111, subdivision (b), where a corporation ceases to be a member of the water's-edge group, the election shall continue in force until the term has expired. A failure to file a notice of nonrenewal shall result in the renewal of the existing contract. For ability to terminate election, see subsection (i) of this regulation.

(e) Time of making the contract. The contract must be entered into at the time the original return for the year is filed and must be signed by an officer of the electing corporation. In the case of an election by the common parent of a controlled group, the contract must be signed by an officer of the common parent. For purposes of this section:

- (1) 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, or, if no return is filed by that date, the first return filed after such date. The contract may not be entered into through an amended return filed after the due date (taking extensions into account) of the original return.

(2) Timely filings which only supplement a previously filed return, or correct mathematical or other errors, shall be considered as incorporating the previously filed return, to the extent not inconsistent, and shall be treated as the original return for purposes of making a water's-edge election if they contain objective evidence of substantial performance as provided in subsection (a)(2) of this regulation. Any filing described in this subsection (e) of this regulation which clearly reflects an intent to withdraw an election made on previously filed return shall be treated as an original return.

EXAMPLE 1: T is a calendar year taxpayer which obtains a seven-month extension of time to file its return.

A. T files its original return on October 15 of the year. The contract shall be entered into on October 15.

B. T files its original return on May 15 of the year. The contract shall be treated as entered into on October 15.

C. T files a return on May 15 and files a second return on October 15. T's original return was filed on October 15. The election must be made by that time. If T's May 15th filing makes a water's-edge election, and the election is withdrawn in the October 15th filing, the election made on May 15th has no effect. If T's May 15th filing did not make a water's-edge election, and a water's-edge election is made on the October 15th filing, T has made a water's-edge election.

EXAMPLE 2. T, a calendar year taxpayer, files a return on February 15. T's return is treated as being filed on March 15, and March 15 is the date the contract is considered to have been entered into. Any return filed after March 15 (the due date of the return) will be considered an amended return.

EXAMPLE 3. T, a calendar year taxpayer, has a due date for its return of March 15. It files a return on February 15 and files a second return on March 10. The return filed on March 10 is treated as the original return for the year. The election to file on a water's-edge basis must be made on the March 10 filing to be effective. If T's February 15 filing makes a water's-edge election and the March 10 filing does not make an election, the election made on the February 15 return has no effect. If T's February 15th filing did not make a water's-edge election, and a water's-edge election is made on the March 10th filing, T has made a water's-edge election.

(f) Length of contract. At the time the contract is entered into, the taxpayer must agree to file on a water's-edge basis for an 84-month period. If a change in accounting periods is made which results in a short period tax year, it shall not shorten the period covered by the contract.

(g) Effect of different fiscal years. In the case of taxpayers which are on different fiscal years, each member of the water's-edge group shall make the election upon its original return for the taxable year for which the election is being made. The election shall become effective as of the beginning of the taxable year of the last member of the water's-edge group to file its return and election. The 84-month election period for each member of the water's-edge group will run from the date that the election becomes effective, i.e., the beginning of the taxable year of the last member of the water's-edge group to elect.

Each taxpayer in the group shall calculate 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.

EXAMPLE: Corporation A and Corporation B are California taxpayers engaged in a unitary business and wish to make a water's-edge election. Corporation A's taxable year ends December 31 and Corporation B's taxable year ends March 31. A files an election for its taxable year ended December 31, 1994, on its return filed on October 15, 1995. B files an election for its taxable year ended March 31, 1995, on its return filed on January 15, 1996.

Corporation A's 84-month election period begins April 1, 1994, the beginning of the taxable year of the last member of the group to elect. Corporation A will file its return for the taxable year ending December 31, 1994, apportioning its income to California on a worldwide basis for the period from January 1, 1994, through March 31, 1994, and on a water's-edge basis for the period from April 1, 1994, through December 31, 1994. Corporation B will file its return for the taxable year ending March 31, 1995, apportioning its income to California on a water's-edge basis for its entire taxable year.

(h) Renewal.

(1) Automatic. Once a contract is entered into, it shall automatically renew on its anniversary date unless a notice of nonrenewal is filed with the Franchise Tax Board. Such renewal shall extend the 84-month period of the contract for an additional 12 months. Except as provided in Revenue and Taxation Code section 25111.1, a contract shall always be in effect 84 months from the beginning of the taxable year covered by the most recent anniversary date absent a notice of nonrenewal.

EXAMPLE: T, a calendar year taxpayer, makes a water's-edge election and enters into an 84-month contract with its return filed March 15, 1995. The contract covers

the taxable years 1994 through 2000. No timely notice of nonrenewal is received prior to the time T files its return for the taxable year 1995 on March 15, 1996. The contract is automatically renewed and extends the election through the taxable year 2001.

(2) Notice of nonrenewal.

(A) In general. A taxpayer may file a notice of nonrenewal at any time within the contract period. A taxpayer may file a notice of nonrenewal at the same time it makes the election. In order to be effective to terminate the automatic renewal provisions, the notice must be delivered to the Franchise Tax Board at least 90 days prior to the anniversary date. Delivery may be made in person or by mail. In the case of a mailed notice, the date of the postmark shall constitute the date of delivery. For a notice of nonrenewal to be effective, it must be entered into or be consented to by all taxpayers which are members of the water's-edge group. A notice of nonrenewal may be filed by the common parent of a controlled group for all California taxpayers.

If a member of the water's-edge group is deemed to have made an election pursuant to the provisions of subsection (d)(2)(A) or (B) of this regulation, such member shall also be deemed to have entered into any notice of nonrenewal filed by the other members of the water's-edge group.

EXAMPLE 1: T, a calendar year taxpayer, makes a water's-edge election and enters into an 84-month contract with its return filed March 15, 1995.

A. T files a notice of nonrenewal on March 15, 1995. The contract shall be in effect for the taxable years 1994 through 2000. For taxable years 2001 and thereafter, T shall file under Revenue and Taxation Code section 25101, unless a new contract is entered into prior to or with the return filed for the taxable year 2001.

B. T files a notice of nonrenewal on February 15, 1996. The original contract was in effect for the taxable years 1994 through 2000. T's notice of nonrenewal is not timely to prevent the automatic renewal as of March 15, 1996. The contract shall be extended for one year and shall include the taxable year 2001. The notice of nonrenewal shall be effective for taxable years 2002 and thereafter.

EXAMPLE 2. T, a calendar year taxpayer, makes a water's-edge election and

enters into an 84-month contract with its return filed May 15, 1995. T had an extension to file its return until October 15, 1995. T files a notice of nonrenewal on July 1, 1996. Since the notice of nonrenewal was filed at least 90 days prior to the anniversary date of October 15, 1996, the contract shall be in effect for taxable years 1994 through 2000.

(B) Effect on election. Serving a notice of nonrenewal shall not terminate the taxpayer's obligation to file pursuant to Revenue and Taxation Code section 25110 until the 84-month period has expired.

(i) Termination of election.

(1) In general. A taxpayer may terminate the election if:

(A) it is acquired directly or indirectly by an unaffiliated non-electing entity which, with those of its affiliates which are included in its combined report, is larger in terms of equity capital than is the taxpayer,

(B) the Franchise Tax Board grants permission.

(2) Acquisition by larger entity.

(A) In general. A taxpayer which is acquired by a larger, unaffiliated entity may request, and the Franchise Tax Board shall allow, the termination of an election effective for the taxable year immediately succeeding the taxable year in which it is acquired, directly or indirectly, by a larger entity. The request must be made no later than the due date of the return (including extensions) for taxable year immediately succeeding the year of acquisition.

(B) For purposes of Revenue and Taxation Code section 25111, subdivision (b)(1), "taxpayer" means the individual corporation with a requirement to file under this part. It does not mean the water's-edge group or all the members of the water's-edge group which are required to file under this part.

(C) Acquisition. A taxpayer is acquired if it, or any entity or entities which own a majority of its voting stock, has a quantity of its voting stock purchased by another entity sufficient to give such entity control of over 50 percent of such stock sufficient so that it may control the affairs of the purchased entity.

(D) The relative size of the taxpayer and the acquiring entity shall be determined by a comparison of their equity capital. For purposes of this provision equity capital includes issued stock of any class, paid in capital, and retained earnings or earned surplus, as set forth on the balance sheet of such entity for the immediately preceding year-end accounting period.

(3) Request for termination of election.

(A) In general. A taxpayer may request permission of the Franchise Tax Board to terminate its election pursuant to Revenue and Taxation Code section 25111, subdivision (b)(2), at any time.

(B) Conditions for granting. The request shall be granted only if the taxpayer demonstrates to the satisfaction of the Board that the requirement to file returns under Revenue and Taxation Code section 25110 rather than under Revenue and Taxation Code section 25101 for the unexpired term of the contract shall result in a significant disadvantage to the taxpayer, and that such disadvantage is the consequence of an extraordinary and significant event which could not have been reasonably anticipated at the time the original election was made.

1. Extraordinary and significant event. For purposes of this subsection an extraordinary and significant event includes but is not limited to:

a. Changes in ownership or affiliation. The acquisition of the taxpayer directly or indirectly by a new owner, the acquisition by the taxpayer or its affiliates of new subsidiaries, or a reorganization or sale or other action resulting in a disaffiliation of the taxpayer from some or all of its affiliates. Changes in ownership or affiliation undertaken for tax avoidance purposes or for purposes of avoiding the water's-edge contract do not constitute an extraordinary or significant event. A request for termination of election made by reason of a change in ownership or affiliation must be made no later than the due date (including extensions) of the return for the taxable year immediately succeeding the taxable year in which the change in ownership or affiliation occurred.

2. Significant disadvantage. A significant disadvantage includes but is not limited to a material difference, which is unfavorable to the taxpayer, between California tax liabilities, computed pursuant to Revenue and Taxation Code sections 25110 and 25101 over the remaining life of the election. Such material difference must be shown in respect of the aggregate tax liabilities of all members of the water's-edge group subject to tax in California. Such

material difference must be demonstrated by reasonable estimates which take into account all currently and readily available pertinent information. The taxpayer must demonstrate that the significant disadvantage is the result of the particular extraordinary and significant event giving rise to the request.

(4) Effective date. Except as otherwise provided, any request granted by the Franchise Tax Board pursuant to subsection (i)(3) of this regulation shall be effective for the taxable year immediately succeeding the taxable year in which the qualifying event occurred. If requested by the taxpayer, the Franchise Tax Board may grant the request effective for some later taxable year. Requests may not be retroactive.

(5) Form and procedures.

(A) Form. A request to terminate an election must be made in writing and it must include a statement of the reason for the request. The request must be mailed to the Franchise Tax Board under separate cover. Requests included in a tax return or enclosed with other correspondence not related to the request to terminate will not constitute adequate notification of a request to terminate the election and will be treated as if not filed.

1. A request made pursuant to Revenue and Taxation Code section 25111, subdivision (b)(1), must include a statement of the facts which demonstrate that the conditions of subsection (i)(2) of this regulation have been satisfied.

2. A request made pursuant to Revenue and Taxation Code section 25111, subdivision (b)(2), must include a statement as to why the requirements of subsection (i)(3)(B) of this regulation are satisfied. It must include an accounting of the gains and losses described in subsections (j)(4) and (5) of this regulation.

(B) Withdrawal. The taxpayer may withdraw its request at any time prior to the Franchise Tax Board's granting permission.

(C) Franchise Tax Board review. In considering a request, the Franchise Tax Board may examine books and records with respect to gains and losses covered by subsections (j)(4) and (5) of this regulation, earnings and profits of affiliated corporations, the nature of the event giving rise to the request, the consequences of such event, and such other relevant matters.

(D) Time of action. Within 90 days of receipt of a request to terminate the election, the Franchise Tax Board shall either act on such request or advise the taxpayer what additional information is needed to consider the request. Following receipt of all such additional information, the Franchise Tax Board shall act on the request within 90 days.

1. If in the case of a request pursuant to Revenue and Taxation Code section 25111, subdivisions (b)(2), the Franchise Tax Board takes no action or requests no additional information, the request is deemed disallowed on the expiration of the 90 days. The taxpayer may grant the Franchise Tax Board additional time to consider the request.

2. If in the case of a request pursuant to Revenue and Taxation Code section 25111, subdivision (b)(1), the Franchise Tax Board takes no action or requests no additional information, the taxpayer shall be deemed to have met the requirements for termination on the expiration of the 90 days.

(j) Conditions of termination of election. If the Franchise Tax Board grants a request to terminate an election pursuant to Revenue and Taxation Code section 25111, subdivision (b)(2), the following conditions shall be imposed as necessary to prevent the avoidance of tax or clearly reflect income for the period the election was, or was purported to be, in effect.

(1) Dividends. Dividends received during the remaining period of the contract from affiliated corporations not described in Revenue and Taxation Code section 25110 shall be considered to have been paid first out of earnings and profits not included in a combined report of a unitary business for purposes of Revenue and Taxation Code section 25106. To the extent dividends exceed such earnings and profits, they may be considered to be subject to Revenue and Taxation Code section 25106.

(2) Gains. Gain on distribution with respect to stock which are not dividends or from the sale or other disposition of assets received during the remaining period of the contract from affiliated corporations not described in Revenue and Taxation Code section 25110 shall not be deferred or eliminated.

(3) Losses. Loss from the sale or worthlessness of stock or from the sale or other disposition of assets of an affiliated corporation not described in Revenue and Taxation Code section 25110 during the remaining period of the contract shall be allowed only to the extent of income or gain recognized by reason of subsections (j)(1) or (j)(2) of this regulation unless such loss would have been recognized on the return filed under Revenue and Taxation Code section 25110.

(4) Gain on water's-edge affiliates. Gain on the disposition of stock of an affiliated corporation which was included in a combined report prior to the election under Revenue and Taxation Code section 25110, or on the disposition of assets of such affiliate, and which was excluded from the combined report by reason of Revenue and Taxation Code section 25110, shall be included in income in the first return filed after the termination of the election.

(5) Losses on water's-edge affiliates. Loss on the disposition of stock of an affiliated corporation which was included in a combined report prior to the election under Revenue and Taxation Code section 25110, or on the disposition of assets of such affiliate, and which was excluded from the combined report by reason of Revenue and Taxation Code section 25110, shall be included in income in the first return filed after permission is granted to the extent that gain is included under subsection (j)(4) of this regulation.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25111, Revenue and Taxation Code.

All language is new and therefore not underlined

REGULATION SECTION 25113

Section 25113 is adopted to read:

§ 25113. Water's-Edge Election.

(a) This regulation shall be applicable to taxable years beginning on or after January 1, 2008.

(b) Definitions. For purposes of Revenue and Taxation Code section 25113 and this regulation, the following definitions are applicable:

(1) 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 Revenue and Taxation Code section 25110 in computing the income of the individual taxpayer for the current taxable year which is derived from or attributable to sources within this state.

(2) 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. A return filed after the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated may be an original return, if no other return has been filed, but it would not be a timely filed, original return.

(3) Timely filed. A timely filed return is one filed on or before the due date (taking extensions into account).

(4) Commencement date. The commencement date of a water's-edge election is the first day of the period for which the election is made. Subsection (c)(6) of this regulation provides rules for taxpayers that have a valid election for taxable years beginning before January 1, 2003.

(5) Net book value. Net book value is equal to an asset's original cost minus depreciation and amortization. Book value means the amount, which an asset is carried on a balance sheet. Depreciation means the systematic write off of the cost of a tangible asset over the asset's useful life. Amortization means the systematic write off of the cost of an intangible asset over the asset's useful life. Book value, depreciation, and amortization will be reflected using United States Generally Accepted Accounting Principles (US GAAP.) If any member of a component unitary group does not maintain its books on US GAAP, the Franchise Tax Board may allow an alternative method of valuation of that member's business assets.

(6) Parent Corporation. A parent corporation of the taxpayer is a corporation that owns or constructively owns stock possessing more than 50 percent of the voting

power of the taxpayer as determined under Revenue and Taxation Code section 25105, subdivisions (e) and (f).

(7) Unitary affiliate group. Unitary affiliate group is all of those corporations that would constitute a unitary group if a water's-edge election were not made.

(8) New unitary affiliate group. New unitary affiliate group is a unitary affiliate group that is created by a new affiliation of two or more corporations, or by the addition of one or more new members to an existing unitary affiliate group.

(9) Component unitary group. Component unitary group is that portion of a group of corporations that have become members of a new unitary affiliate group that were members of their own respective unitary affiliate group prior to entering the new unitary affiliate group, disregarding any corporations that did not become part of the new unitary group.

(10) Business assets. Business assets are assets, including intangible assets, other than stock of a member of the unitary affiliate group, which are used in the conduct of the business of the unitary affiliate group or would produce business income to the unitary affiliate group, if an election were not in place, if the assets were sold.

Business assets are valued at net book value as of the date that electing taxpayers and nonelecting taxpayers or non-taxpayers become members of a new unitary affiliate group. A copy of the taxpayer's valuation of the business assets shall be attached to the return for which the valuation is required by Revenue and Taxation Code section 25113. The Franchise Tax Board may, in its sole discretion, allow an alternative valuation date if it determines that an alternative date would be more appropriate.

(11) Taxpayer. Taxpayer means the individual corporation with a requirement to file under this part. It does not mean the water's-edge group or all the members of the water's-edge group that are required to file under this part.

(12) Good cause. Good cause shall have the same meaning as specified in Treasury Regulation section 1.1502-75(c).

(13) Common parent election. A common parent election may be made by a parent corporation that is an electing taxpayer or by an officer or other authorized agent of either a parent corporation of a nonelecting taxpayer or another corporation with authority to bind a nonelecting taxpayer to an election. Either subsection (c)(2)(A)1. or 2. of this regulation would constitute a common parent election.

(c) Electing water's-edge.

- (1) To make the water's-edge election permitted by Revenue and Taxation Code section 25110, a taxpayer must make an election on a timely filed, original return for

the year of the election. The election must be made by every member of the self-assessed combined reporting group that is subject to taxation under this part. The initial election must be for an 84-month period. A water's-edge election shall remain in effect until terminated.

- (2) An election made on a group return of a self-assessed combined reporting group is an election by each taxpayer member included in that group return. No election will have been made if a taxpayer member of the combined reporting group files a separate return in which no election is made and subsection (c)(3) does not apply.

(A) A taxpayer that fails to make an election on its own timely filed, original return shall be deemed to have elected if any of the following apply:

1. It has a parent corporation that is an electing taxpayer that included the income and apportionment factors of the nonelecting taxpayer in the self-assessed combined reporting group reflected in the electing parent's timely filed, original return, including a group return.

2. The income and apportionment factors of the nonelecting taxpayer are reflected in the self-assessed combined reporting group of a timely filed, original return of an electing taxpayer, and the notification of election filed by the electing taxpayer pursuant to Revenue and Taxation Code section 25113, subdivision (a)(2) is signed by an officer or other authorized agent of either a parent corporation of the nonelecting taxpayer or another corporation with authority to bind the nonelecting taxpayer to an election.

EXAMPLE: 1. Corporation P, a California taxpayer and a calendar year taxpayer, has a subsidiary, Corporation A, who is also a California taxpayer and calendar year taxpayer.

- A. Corporation P makes a common parent water's-edge election and includes its subsidiary Corporation A in the combined report used to determine its California income. Corporation A files a separate return using a worldwide combined report that includes Corporation P. Corporation A is deemed to have elected.
- B. Corporation P, a California taxpayer, timely files a single group return on a combined basis for all members of the water's-edge group and includes the income and apportionment factors (both numerators and denominators) of Corporation A. Corporation A files a separate return and files on a worldwide basis. Corporation A is deemed to have elected.

EXAMPLE: 2. Corporation P has subsidiaries, Corporations A, B and C. Corporations A and C are California taxpayers, Corporations P and B are not.

- A. Corporation B's President has a power of attorney for every member of Corporation P's commonly controlled group, including Corporation A.

Corporation C timely files its own return on a combined basis including the income and factors of Corporation A and other members of the water's-edge group. Corporation B's President signs a common parent election that lists all taxpayer members of Corporation P's commonly controlled group as making a water's-edge election. Corporation A files a separate return on a worldwide basis. Corporation A is deemed to have elected.

- B. Corporation P's Chief Executive Officer signs the notification of election and indicates that it is making a common parent election which Corporation B, a taxpayer member of the water's-edge group, includes with its timely filed, original return filed on a water's-edge basis. Corporation A files a separate return on a worldwide basis. Corporation A is deemed to have elected.

EXAMPLE: 3. Corporation P is not a California taxpayer, but it has subsidiaries A, B and C that are taxpayers and are part of its unitary business. No common parent election has been filed prior to the due date (taking extensions into account) for filing a return. After the due date (taking extensions into account), a delinquent original California return is filed with a common parent election by Corporation P, stating that it now believes it had nexus in California. Because the election was not made on a timely filed, original return, there is no valid election.

EXAMPLE 4. Corporation P, the parent corporation and a calendar year taxpayer, makes a common parent water's-edge election and includes its subsidiary, Corporation A, also a calendar year taxpayer, as a member of the water's-edge group. Corporation P and Corporation A have different fiscal years. Corporation P's taxable year ends March 31 and Corporation A's taxable year ends December 31. Corporation P files its March 31, 2008 taxable year return on January 15, 2009 on a combined basis, which includes Corporation A. Corporation A files its December 31, 2008 return on October 15, 2009 on a separate company worldwide basis. Corporation A is deemed to have elected. Corporation A's and Corporation P's election commencement date is determined in accordance with the provisions of subsection (g) of this regulation.

3. If a corporation that is a member of a combined reporting group is not itself subject to taxation under Part 11 in the year for which the water's-edge election is made, but subsequently becomes subject to taxation under Part 11, that corporation shall be deemed to have elected with the other taxpayer members of the combined reporting group.

4. A corporation that is a nonelecting taxpayer and is subsequently proved to be member of the water's-edge group pursuant to a Franchise Tax Board audit determination shall be deemed to have elected if the value of the total business assets of the electing taxpayers is greater than those of the non-electing taxpayers.

For purposes of applying the business asset test of this subsection, the term "business assets" shall have the same meaning as Revenue and Taxation Code section 25113, subdivision (c)(6)(A), except that the business assets of other

members of the unitary affiliate group that are not taxpayers shall not be taken into account.

(B) A taxpayer that is engaged in more than one apportioning trade or business as defined in Revenue and Taxation Code section 25128, subdivision (d)(6), may make a separate election for each apportioning trade or business.

(3) Validity of Election. The election shall be considered valid if the following are satisfied:

(A) The tax is computed in a manner that is consistent with a water's-edge election, and

(B) The taxpayer files its return on a form 100W (S Corporations file a form 100S) and attaches a form 100-WE.

(C) In place of subsection (c)(3)(B), the Franchise Tax Board may consider other objective evidence of the making of a water's-edge election, such as:

1. A statement attached to the timely filed, original return indicating a water's-edge election is being made, or
2. The taxpayer's timely filed, original return includes one or more substantially completed forms associated with a water's-edge combined report, such as FTB form 1115, 2416, 2424, or their successors.

(4) Time of making the election.

(A) The election must be made on a timely filed, original return.

(B) Timely filings which only supplement a previously filed return, or correct mathematical or other errors, shall be considered as incorporating the previously filed return, to the extent not inconsistent, and shall be treated as the original return for purposes of making a water's-edge election if they contain objective evidence that supports the conclusion that a water's-edge election was intended as provided in subsection (c) of this regulation. Any filing described in this subsection (c) of this regulation that clearly reflects an intent to withdraw an election made on previously filed return shall be treated as an original return.

EXAMPLE 1: Corporation A is a calendar year taxpayer. Its return is due March 15. But if it files its return on or before October 15, an extension is automatically granted to October 15. If it fails to file a return by October 15, no extension exists. Under the paperless extension process, the return is timely if it is filed on or before October 15.

- a. Corporation A files its original return on October 15 of the year. The original return is timely filed, and any water's-edge election contained therein shall be effective for the year for which the return is filed.

b. Corporation A files its original return on May 15 of the year. The original return is timely filed, and any water's-edge election contained therein shall be effective for the year for which the return is filed.

c. Corporation A files a return on May 15 and files a second return on October 15. Corporation A's original return was filed on October 15. The water's-edge election must be made by that time. If Corporation A's May 15th filing makes a water's-edge election, and the election is withdrawn in the October 15th filing, the election made on May 15th has no effect. If Corporation A's May 15th filing did not make a water's-edge election, but a water's-edge election is made on the October 15th filing, Corporation A has made a water's-edge election.

EXAMPLE 2: Corporation B, a calendar year taxpayer, files a return on February 15. Corporation B's return is treated as being filed on March 15, and March 15 is the date the election is considered to have been made. Any return filed after March 15 (the due date of the return) will be considered an amended return.

EXAMPLE 3: Corporation C, a calendar year taxpayer, has a due date for its return of March 15. It files a return on February 15 and files a second return on March 10. The return filed on March 10 is treated as the original return for the year. The election to file on a water's-edge basis must be made on the March 10 filing to be effective. If Corporation C's February 15 filing makes a water's-edge election and the March 10 filing does not make an election, the election made on the February 15 return has no effect. If Corporation C's February 15th filing did not make a water's-edge election, and a water's-edge election is made on the March 10th filing, Corporation C has made a water's-edge election.

(5) A copy of the original election should be attached to all subsequent returns filed during the election period.

(6) Corporations that have a valid election for taxable years beginning before January 1, 2003, and are required to file on a water's-edge basis for taxable years beginning on or after January 1, 2003 due to that election, will continue to file on a water's-edge basis and will be deemed to have elected under Revenue and Taxation Code section 25113 for taxable years beginning on or after January 1, 2003. The commencement date, as elected under Revenue and Taxation Code section 25111, remains in effect.

EXAMPLE 1: Corporation A, a calendar year taxpayer, elected to file on a water's-edge basis starting January 1, 2000. For taxable years beginning on or after January 1, 2003, Corporation A must continue to file on a water's-edge basis and is deemed to have elected under the new statute. Under Revenue and Taxation Code section 25111, subdivision (a), a taxpayer would always have an 84-month contract on its anniversary date unless it filed a notice of nonrenewal. Although

Corporation A originally entered into a water's-edge contract commencing on January 1, 2000, an additional year would have been added to the contract each year unless a notice of nonrenewal was filed pursuant to Revenue and Taxation Code section 25111. The election commencement date for purposes of Revenue and Taxation Code section 25113 is January 1, 2002.

For the year beginning January 1, 2009, and each year thereafter, Corporation A may file on a water's-edge basis without being subject to a new 84-month election period or may terminate its election by filing on a worldwide basis.

EXAMPLE 2: Corporation B, a calendar year taxpayer, made a water's-edge election beginning January 1, 1994, and filed a notice of nonrenewal to end the contract on December 31, 2001. Corporation B did not file a new contract for the taxable year ended on December 31, 2002, but continued to file on a water's-edge basis on a timely filed, original return that contained other objective evidence of an intended water's-edge election. Corporation B has a new water's-edge election with a commencement date of January 1, 2002. Corporation B may not terminate its water's-edge election for any year prior to the expiration of the 84-month period without the Franchise Tax Board's consent as provided under Revenue and Taxation Code section 25113, subdivision (c)(9). It could terminate without the Franchise Tax Board's consent only after the 84-month period that ends December 31, 2008.

Corporation B's election, entered into for the 1994 taxable year, ended on December 31, 2001, because the filing of the notice of nonrenewal prevented automatic annual renewal of the contract. However, for the taxable year ended December 31, 2002, Corporation B had a valid new water's-edge contract, because there was substantial performance of the requirements for entering into a water's-edge contract. Therefore, Corporation B had a new water's-edge contract with a commencement date of January 1, 2002. As a consequence, under Revenue and Taxation Code section 25111, subdivision (f), and section 25113, subdivision (f), Corporation B's commencement date of the election is January 1, 2002. Because Corporation B's election will not have been in existence for 84 months until after December 31, 2008, it must obtain the Franchise Tax Board's consent to terminate the election before then.

EXAMPLE 3: Corporation C elected to file on a water's-edge basis beginning April 1, 1995, for its fiscal year ended March 31, 1996. Corporation C filed a notice of nonrenewal to end the contract on March 31, 2003. For the taxable year ended March 31, 2004, Corporation C filed on a worldwide basis. Corporation C may make a water's-edge election without the Franchise Tax Board's consent for a taxable year that begins within the 84-month period after March 31, 2003.

Corporation C's election contract under Revenue and Taxation Code section 25111 ended on March 31, 2003, due to the previously filed notice of nonrenewal. Revenue and Taxation Code section 25113 is operative with respect to Corporation C for its taxable years beginning on or after April 1, 2003. Therefore,

Corporation C could have made an election under Revenue and Taxation Code section 25113, but it chose to file its return for the taxable year ended March 31, 2004, on a worldwide basis.

The filing on a worldwide basis for the year ended March 31, 2004, did not constitute a "termination" of a water's-edge election under Revenue and Taxation Code section 25113, because Corporation C had not made a water's-edge election for any taxable year beginning on or after January 1, 2003. For taxable years beginning after March 31, 2003, Corporation C may file on a worldwide basis and may make a water's-edge election under Revenue and Taxation Code section 25113 without requesting the Franchise Tax Board's consent to "re-elect."

EXAMPLE 4: Corporation D elected to file on a water's-edge basis beginning April 1, 1996, for its fiscal year ended March 31, 1997. Corporation D filed a notice of nonrenewal to end the contract on March 31, 2004. For the taxable year ended March 31, 2005, Corporation D filed on a worldwide basis. Corporation D effectively terminated its water's-edge election pursuant to Revenue and Taxation Code section 25113, subdivision (c)(9), when it filed on a worldwide basis for the taxable year ended March 31, 2005. Corporation D's filing of the notice of nonrenewal under section 25111 has no effect because it caused the water's-edge contract to end on a date that falls within a taxable year that begins on or after January 1, 2003. Corporation D would not be able to make another election without the Franchise Tax Board's consent until 84 months have passed from March 31, 2004.

EXAMPLE 5: Corporation E elected to file on a water's-edge basis beginning January 1, 1994, and filed a notice of nonrenewal to end the contract on December 31, 2006. Corporation E must request the Franchise Tax Board's consent to terminate the election prior to December 31, 2006.

Under Revenue and Taxation Code section 25111, subdivisions (d) and (e), Corporation E's existing election remains in effect for the "balance of the period remaining since the original election or the last renewal of the election" unless it serves written notice of nonrenewal at least 90 days prior to the annual renewal date. Under Revenue and Taxation Code section 25111, subdivision (a), a taxpayer would always have an 84-month contract on its anniversary date, unless it filed a notice of nonrenewal. Although Corporation E originally entered into a water's-edge contract commencing on January 1, 1994, an additional year would have been added to the contract each year until a notice of nonrenewal was filed. In order to terminate its contract for years after December 31, 2006, Corporation E would have had to complete a contract period of 84 months on December 31, 2006. As of January 1, 2003, Corporation E is deemed to have elected under Revenue and Taxation Code section 25113, with a commencement date of January 1, 2000, 84 months prior to December 31, 2006.

Under Revenue and Taxation Code section 25113, subdivision (f), the commencement date of the election made in a prior year under Revenue and

Taxation Code section 25111 is treated as the commencement date for purposes of applying Revenue and Taxation Code section 25113. Because Corporation E's election would not have been in effect for longer than 84 months, it may not terminate the election as permitted under Revenue and Taxation Code section 25113, subdivision (c)(9), by timely filing an original tax return on form FTB 100 on a worldwide basis until after December 31, 2006. In order to terminate the election prior to December 31, 2006, the taxpayer must request and receive consent from the Franchise Tax Board under Revenue and Taxation Code section 25113, subdivision (c)(10).

(d) Termination.

(1) A water's-edge election may be terminated after the expiration of the initial 84-month period. This termination does not require Franchise Tax Board consent.

a. The termination shall be made on a timely filed, original return computed on a worldwide basis for the first year in which the water's-edge election is to be terminated.

b. The termination shall be made by every taxpayer that is a member of the water's-edge group.

c. The termination shall be effective if the termination is made in the same manner as the election provided under Revenue and Taxation Code section 25113, subdivisions (a) and (b).

d. Written notification of termination shall be made on a form prescribed by the Franchise Tax Board. The Franchise Tax Board may accept other objective evidence of termination of the water's-edge election such as:

1. A timely filed, original return computed on a worldwide basis using form FTB 100 rather than form FTB 100W, or

2. A statement attached to the timely filed, original return indicating a water's-edge election is being terminated.

(2) The Franchise Tax Board may consent to terminate a water's-edge election prior to the expiration of the 84-month period if a request is made demonstrating good cause.

a. A request to terminate a water's-edge election shall be made on a form prescribed by the Franchise Tax Board and be filed no later than the 120th day prior to the due date of the return for which the termination would be effective, including extensions. The request shall be filed separate from any tax return and shall be mailed to the address listed in the form instructions for the notification of termination form prescribed by

the Franchise Tax Board. The request shall include information and documentation of the basis for requesting termination.

b. If the Franchise Tax Board takes no action or requests no additional information within 90 days of the filing of the request to terminate the water's-edge election, the request shall be deemed to be disallowed.

c. If the request is granted, the Franchise Tax Board will send a notification of the termination. The termination will be effective for the taxable year in which good cause occurred. Thereafter, the taxpayer will be required to file on a worldwide basis for at least 84 months before making another water's-edge election.

d. A request to terminate a water's-edge election in order to permit the state to contract with an expatriate corporation, or its subsidiary, pursuant to paragraph (2) of subdivision (b) of Section 10286 of the Public Contract Code, shall be made on a form prescribed by the Franchise Tax Board. The request shall be filed separate from any tax return and shall be mailed to the address listed in the form instructions for the form for requesting permission to terminate prescribed by the Franchise Tax Board.

1. A request to terminate a water's-edge election under Revenue and Taxation Code section 25113, subsection (c)(10)(B), shall be made on a form prescribed by the Franchise Tax Board and be filed no later than the 120th day prior to the due date of the return for which the termination would be effective, including extensions. All members of the water's-edge group must make the request. Such request shall also include source documentation to support the request.

2. A water's-edge election terminated pursuant to this subsection shall be effective for the year in which the expatriate corporation, or its subsidiary, enters into the contract with the state.

3. The Franchise Tax Board shall consent to a properly filed and documented request to terminate pursuant to Revenue and Taxation Code section 25113, subsection (c)(10)(B).

e. The taxpayer may withdraw its request at any time prior to the Franchise Tax Board granting permission.

(3) The water's-edge election shall be automatically terminated in certain instances. Written notification of termination shall be made by every taxpayer that is a member of the water's-edge group on a form prescribed by the Franchise Tax Board.

a. If an electing taxpayer and a nonelecting taxpayer become members of a new unitary affiliate group and the value of the total business assets of the nonelecting taxpayer (and affiliates, if any) is greater than those of the electing taxpayer (and affiliates, if any), the election shall be automatically terminated.

b. If an electing taxpayer and a nonelecting taxpayer become members of a new unitary affiliate group during the taxable year, the electing taxpayer (and affiliates, if any) shall compute its tax liability on a water's-edge basis until the termination. The electing taxpayer (and affiliates, if any) shall compute its tax liability for the remaining portion of the taxable year after the termination as part of the nonelecting taxpayer's unitary affiliate group. The nonelecting taxpayer (and affiliates, if any) shall compute its tax liability on a worldwide basis for the entire year.

(e) Re-election.

(1) A water's-edge election remains in effect until terminated. If a taxpayer terminates its water's-edge election and returns to filing on a worldwide basis, then another water's-edge election may not be made for any taxable year that begins within the 84-month period following the last day of the election period that was terminated. However, the Franchise Tax Board may waive the application of this rule for good cause.

(2) A request to re-elect water's-edge shall be made on a form prescribed by the Franchise Tax Board and be filed no later than the 90th day prior to the due date of the return for which the re-election would be effective, including extensions. The request shall be filed separate from any tax return and shall be mailed to the address listed in the form instructions for the form for requesting re-election prescribed by the Franchise Tax Board. The request shall include information and documentation of the basis for requesting re-election.

a. If the Franchise Tax Board takes no action or requests no additional information within 60 days of the filing of the request to re-elect water's-edge, the request shall be deemed to be disallowed.

b. If the Franchise Tax Board approves the request for re-election, the taxpayers must then make a water's-edge election as provided in subsection (c). Such election will be effective for the taxable year in which good cause occurred. Consent given by the Franchise Tax Board will not be retroactive.

c. The taxpayer may withdraw its request at any time prior to the Franchise Tax Board granting permission.

(3) Consent for re-election is not required if the election was terminated under Revenue and Taxation Code section 25113, subdivisions (c)(2), (4), and

(5). In this case, taxpayers may simply make an election as provided in Revenue and Taxation Code section 25113, subdivisions (a) and (b).

(4) Consent for re-election is not required if the 84-month period following the last day of an election period that was terminated has passed. Taxpayers may simply make an election as provided in Revenue and Taxation Code section 25113, subdivisions (a) and (b).

(f) Election, those affected.

(1) In general. The water's-edge election, to be effective, must be made by all corporations required to file under this part that are part of the water's-edge group. A taxpayer or a group of affiliated taxpayers that is engaged in more than one unitary business may make a water's-edge election with respect to one or more of the businesses, but it need not elect for all of its businesses.

EXAMPLE: Corporations A and B are members of an affiliated group which includes Corporations C, D, E and F, all incorporated in the United States, and Corporations G, H and I, all incorporated outside of the United States. Corporations A and B are taxpayers, but are not engaged in the same unitary business. Corporations G, H and I have no factors in the United States, no United States source income, and have no Subpart F income. Corporations A, C, D and G are engaged in one unitary business. Corporations B, E, F, H and I are engaged in a separate unitary business. Either Corporation A or B may elect to file on a water's-edge basis pursuant to Revenue and Taxation Code section 25110. It is not necessary for both Corporations A and B to make a water's-edge election.

(2) In general, the water's-edge filing status of a combined reporting group that has changes in affiliation will depend upon the status of the taxpayer (and affiliates, if any) with the greater value of total business assets.

(A) If one or more electing taxpayer members of a combined reporting group for any reason leave the group, the water's-edge election remains in effect as to the departing taxpayer members and any remaining taxpayer members.

(B) If electing taxpayers with different election commencement dates become members of a new group, the election commencement date of the new group shall be the commencement date of the taxpayer (and affiliates, if any) whose total business assets are the largest.

(C) If an electing taxpayer and a non-electing taxpayer or a non-taxpayer become members of a new unitary group, the nonelecting taxpayer shall be deemed to have elected if the value of the total business assets of the electing taxpayer (and affiliates, if any) is greater than those of the non-

electing taxpayer or non-taxpayer (and affiliates, if any.) Otherwise, the election shall automatically be terminated at the time the electing members become part of the combined report.

(D) If two non-electing taxpayers with different termination dates become members of a new group, the termination date, together with any associated restrictions on re-election, of the taxpayer (and affiliates, if any) whose total business assets are the largest shall be the termination date of the new group.

EXAMPLE 1: Corporation A, an electing taxpayer, and its unitary subsidiaries are acquired by Corporation B, a non-taxpayer and its non-taxpayer unitary subsidiaries, that have the larger total value of business assets than those of Corporation A's group and become instantly unitary. The new unitary group will file on a worldwide basis as of the date of combination because Corporation B's group has the larger total value of business assets than Corporation A's group and the water's-edge election is terminated. However, if the new group wants to file on a water's-edge basis, the taxpayer members may re-elect without Franchise Tax Board consent for the year in which the election was terminated or any year thereafter, with a new commencement date for the 84-month election period. If the re-election is for the year in which the group becomes properly combined, the commencement date will be the date of combination.

EXAMPLE 2: Corporation B, a nonelecting taxpayer, and its unitary subsidiaries are acquired by Corporation A, an electing taxpayer and its unitary subsidiaries, that has the larger total value of business assets than those of Corporation B's group. In the year the entire group is properly combined, the group will file on a water's-edge basis because Corporation A's group has the larger total value of business assets than Corporation B's group. The start date of the deemed election is the commencement date of Corporation A's election.

EXAMPLE 3: Corporation A and its unitary subsidiaries' election has been terminated and the group becomes a member of Corporation B's unitary group that includes one or more non-electing taxpayers that have no restrictions upon their ability to elect. The total value of business assets of Corporation A and its unitary subsidiaries is larger than that of Corporation B's group. All members of the new Corporation B group that includes Corporation A will be restricted from making a new election for the period of time for which Corporation A is restricted.

EXAMPLE 4: Same facts as EXAMPLE 3, except that Corporation B's taxpayer members have no restrictions upon their ability to elect and have the larger total value of business assets. In this situation, none of the taxpayer members of the new Corporation B group that includes Corporation A will be subject to any restrictions on making a new water's-edge election.

(g) Effect of different fiscal years. In the case of taxpayers that are on different fiscal years, each member of the water's-edge group shall make the election upon its timely filed, original return for the taxable year for which the election is being made. The election shall become effective as of the beginning of the taxable year of the member of the water's-edge group that files its return and election and has the latest taxable year end. The 84-month election period for each member of the water's-edge group will run from the date that the election becomes effective, i.e., the beginning of the taxable year of the last member of the water's-edge group to elect.

Each taxpayer in the group shall calculate 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.

EXAMPLE: Corporations A and B are California taxpayers engaged in a unitary business and wish to make a water's-edge election. Corporation A's taxable year ends December 31 and Corporation B's taxable year ends March 31. Corporation A files an election for its taxable year ended December 31, 2007, on its return filed on October 15, 2008. Corporation B files an election for its taxable year ended March 31, 2008, on its return filed on January 15, 2009.

Corporation A's 84-month election period begins April 1, 2007, the beginning of the taxable year of the last member of the group to elect. Corporation A will file its return for the taxable year ending December 31, 2007, apportioning its income to California on a worldwide basis for the period from January 1, 2007, through March 31, 2007, and on a water's-edge basis for the period from April 1, 2007, through December 31, 2007. Corporation B will file its return for the taxable year ending March 31, 2008, apportioning its income to California on a water's-edge basis for its entire taxable year.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25113, Revenue and Taxation Code.