INITIAL STATEMENT OF REASONS FOR THE AMENDMENT OF REGULATIONS 25111 and 25111-1

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE AMENDMENTS TO THE REGULATIONS ARE INTENDED TO ADDRESS

For income years beginning on or after January 1, 1988, corporate taxpayers are permitted to make a water's-edge election, Sections 25110 et. seq. Revenue and Taxation Code. This election allows taxpayers to exclude the income and activities of various entities organized in foreign countries from the combined report used to determine the income derived from or attributable to California. This election is made by a contract which must be entered into by all members of the water's-edge combined report group which are California taxpayers. The Legislature, in adopting the water's-edge provisions, intended to provide taxpayers with a choice of filing methods. There was no intent to make compliance difficult. There was an intent, as evidenced by the length of the contract period, that taxpayers, once electing, were to be bound by that election.

The water's-edge provisions established a new and non-traditional mechanism for making a tax election. Elections were made pursuant to a contract which was effective for multiple years. Many taxpayers made unintended errors in attempting, in good-faith, to enter into the contract. Since enactment, the water's-edge election provisions have been amended several times to change the terms of the contract. These amendments have added additional complexity to the making of a water's-edge election and have given rise to additional good-faith errors by taxpayers endeavoring to make an election. In many cases these errors could not be determined until an audit of the taxpayer's returns was performed. Audits normally take place several years after returns are filed. Because taxpayers were unaware that they had not complied with the requirements to make an election, later year's returns were affected.

The making of a water's-edge election can have significant consequences for taxpayers both in terms of the actual tax to be paid and in terms of administrative costs involved in filing the tax return.

Section 25111 of the Revenue and Taxation Code is the statutory provision describing how the election is to be made by contract. Current Regulation 25111 establishes rules for making a contract for income years beginning prior to January 1, 1994, and Regulation 25111-1 establishes the rules for making a contract for income years beginning on or after January 1, 1994.

As of March of 1998, the Franchise Tax Board's audit staff determined that a total of 149 taxpayers which attempted to make

a water's-edge election had been unsuccessful because of the stringent requirements of the current regulations. In most of these cases there is objective evidence which establishes that a water's-edge election was intended by the taxpayer.

SPECIFIC PURPOSE OF THE AMENDMENTS TO THE REGULATIONS

The proposed amendments to the regulations are intended to allow a water's-edge election in circumstances where there is objective evidence that an election was intended and that the non-compliance with the provisions of the current regulation was unintentional.

Subsection (a) of the regulations is amended to incorporate contract standards of substantial performance as evidence of whether a valid contract is present. "Substantial performance" is defined and examples are provided of the type of objective evidence which supports a finding of substantial performance. New language is also added to provide that corporate entities whose disallowed water's-edge elections are validated as a result of these amendments to the regulation, which are acquired by another entity, and file on a non-water's-edge basis will be deemed to have terminated their election.

Subsections (c) and (d) of the regulations are amended to provide that an election by a common parent corporation is controlling over any other actions by subsidiaries of the common parent. Examples of the operation of this amendment are provided.

Subsection (e) of the regulations is amended, in the case of a return filed pursuant to an extension, to define "original" as the last return filed prior to the extended due date. This results in defining original return in the case of an extension in the same manner as it is defined for purposes of a return filed by the statutory due date. The definition of "original" return when a return is filed pursuant to an extension is consistent with federal Internal Revenue Code authorities. The examples are modified accordingly.

Clarifying, nonsubstantive amendments are proposed with respect to subsection (g) of the regulations. A clarifying nonsubstantive, amendment is also proposed with respect to Subsection (i) of Regulation Sections 25111 and 25111-1.

NECESSITY

The proposed amendments are necessary to ensure that taxpayers that intended to enter into a water's-edge contract and have proceeded on the assumption that they successfully did so can be found to have done so. Without these proposed amendments to the Regulations a significant number of taxpayers will be denied the ability to file on a water's-edge basis even though they have clearly evidenced an intent to do so.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS.

The Audit staff of the Franchise Tax Board has prepared a report detailing the circumstances of those taxpayers which have unsuccessfully attempted to make a water's-edge election. The proposed amendments have been applied to those circumstances and a determination has been made that in most circumstances the election intended by the taxpayer will be recognized. A copy of the report is available and is part of the rulemaking file with respect to the proposed amendments.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESSES.

The Franchise Tax Board has determined that there are no alternatives which would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulation. In addition, the proposed regulation pertains to corporate taxpayers and therefore does not affect private individuals.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Economic and Statistical Research Bureau of the Franchise Tax Board has prepared an analysis, dated February 24, 1998, determining that there would be very little economic impact from these regulations.