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09.08.17

Chief Counsel Ruling 2017 -- 02

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RE: Request for Chief Counsel Ruling **************. **********

Dear *********:

In correspondence dated June 23, 2017, you requested a Chief Counsel Ruling from the Franchise Tax Board ("FTB") seeking guidance on the inclusion of goodwill for applying the "deemed water's-edge election" business asset test per California Revenue and Taxation Code ("R&TC") section 25113(c)(2).[1]

** represents that the issues in this ruling request are not the subject of an existing California audit, protest, or litigation concerning the Company.

FACTS

The Company represents the facts as set forth below:

************** is an ********-based ********* ********* and ********* ** ********* ***********. As of ******** **, ****, the Company operated in ***** states, including California.

The Company requested this ruling to properly calculate its Net Operating Losses ("NOLs") due to the uncertainty of a deemed water's-edge election relating to the ***** **** acquisition that created its ultimate parent, **** ***** *** ("Ultimate Parent"), as detailed below.

***** **** *Acquisition*

************* **** ("the Acquirer") acquired ***** ****** *** and affiliates ("the Target") on **** * ****. The newly combined company was renamed ***** **** *** ("New Company").

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[1] Unless otherwise specified, "R&TC section" or "R&TC §" references are to the California Revenue and Taxation Code currently in effect and "CCR section" or "CCR §" references the California Code of Regulations, title 18, currently in effect.

Prior to the acquisition, the Acquirer and the Target were competing ****** *** ** *** based in the ************. The Acquirer acquired 100 percent of the issued share capital of the Target for **********, including the assumption of the Target's outstanding liabilities.

Because financial accounting rules require an acquired company's assets be re-valued to fair market value upon acquisition, the Target's assets were restated to fair market value. Following the acquisition, the Company's **** consolidated financial statement detail report did not attribute goodwill to any specific legal entity and instead goodwill was recorded in a distinct column.

As of ******* * ****, the net book value of business assets of the Acquirer and the Target was ************ and ************, respectively. The Target's net book value of business assets included goodwill in the amount of *********** due to acquisition accounting rules promulgated through the International Financial Reporting Standards ("IFRS").

California Tax Filing History

Leading up to the **** acquisition, the Acquirer filed on a worldwide basis while the Target filed on a water's-edge basis. The Company concluded that it was unitary and, as of **** * ****, the Acquirer had the larger value of business assets than the Target. Thus, the Company filed prospectively on a worldwide basis.

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** ****, *** *** ****** ** **** ** ** ***** **** *** ** **** **** **** *****. ****** ****** ******** ******** ********** ** ***** ***** ** ****** ****** ********* **** *** *** ******* ****. *** ***** **** **** ****** ******* **** **** **** *** ***** ******** * ****.

ISSUE

Whether goodwill, recorded as a result of the Acquirer's acquisition of the Target, should be reflected in the total business assets of the Target, so that the Target's total business assets value was greater than that of the Acquirer, and the Acquirer was thus deemed to have made a water's-edge election per R&TC section 25113(c)(2) when the new unitary affiliate group was established on ******** * ****?

HOLDING

Goodwill recorded as a result of the Acquirer's acquisition of the Target should be reflected in the total business assets of the Target, resulting in a greater value of the Target's total business assets than that of the Acquirer when the new unitary affiliate group was established on ******* * ****. Accordingly, pursuant to R&TC section 25113(c)(2), the Acquirer was deemed to have made a water's-edge election.

DISCUSSION

Deemed Water's-Edge Election

California requires unitary groups to file on a worldwide combined basis unless an election is made to file a water's-edge combined report. Both a water's-edge election and a deliberate termination of a water's-edge election are generally binding for 84 months.[2] R&TC section 25113(c) and the regulation thereunder address the effect of water's-edge elections due to corporate events such as acquisitions, mergers, consolidations, or disaffiliations between electing and non-electing affiliates after a valid election is made.

R&TC section 25113(c)(2) specifically states:

> If an electing taxpayer and a nonelecting taxpayer become members of a new unitary affiliate group, the nonelecting taxpayer shall be deemed to have elected if the value of the total business assets of the electing taxpayer, and its component unitary group, if any, is larger than the value of the total business assets of the nonelecting taxpayer, and its component unitary group, if any. Otherwise, the water's-edge election shall be automatically terminated at the time electing members become part of the combined report. For purposes of applying paragraphs (9) and (10), the commencement date of the deemed election shall be the same as the commencement date of the electing taxpayers.

"Business assets" as defined under R&TC section 25113(c)(6)(A) includes intangible assets, except the stock of a member of the unitary affiliate group, which is used in the conduct of the business of the unitary affiliate group. This definition of business assets is broad. No exception to the statute or regulations specifically excludes goodwill from the definition of business assets for purposes of calculating the business asset test. Therefore, goodwill should be included in the calculation of the business asset test for purposes of R&TC section 25113(c)(2).

In this regard, business assets are valued at their net book value as of the date the electing taxpayers and non-electing taxpayers or non-taxpayers become members of a new unitary affiliate group.[3] The valuation of a business asset for purposes of R&TC section 25113(c)(2) necessitates appropriate adjustments per the "net book value" definition in CCR section 25113(b)(5):

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[2] R&TC § 25113(c)(11) and CCR § 25113(c)(1).
[3] CCR § 25113(b)(10). The phrase "new unitary affiliate group" refers to a unitary 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. R&TC § 25113(c)(6)(C).

> Net book value is equal to an asset's original cost minus depreciation, depletion and amortization. Book value means the amount which an asset is carried on a balance sheet. .... Book value . . . 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.

Goodwill is generally defined as the excess of the purchase price of a company over its book value, which represents the value of goodwill as an intangible asset for accounting purposes.[4] According to United States Generally Accepted Accounting Principles ("US GAAP") and the IFRS, goodwill is not amortized, and instead a determination of an impairment is generally required on a yearly basis.[5] Therefore, in order to accurately reflect the value of goodwill for the business asset test, an impairment or other reevaluation must be considered under US GAAP or an equivalent accounting method.[6]

The Company represents that between the acquisition on **** * **** and the FTB determination that the Acquirer and the Target became unitary as of ****** * ****, it had made all the appropriate accounting adjustments to reflect the accurate goodwill net book value of ********** on that date per CCR section 25113(b)(5).[7]

Attribution of Goodwill

From an income tax perspective, the courts have recognized goodwill is inseparable from a particular business's ongoing operations. In *Pfleghar Hardware Specialty Co. v. Blair,* the court explained:

> Good will [*sic*] has no existence except in connection with a going business; it cannot be separated from the going business to which it is incident. A seller who disposes of his manufacturing plant as a going concern necessarily parts with all those advantages which are inherent in conducting an established business at that plant; in other words, parts with his good will [*sic*] [Citations omitted].[8]

California case law implies that goodwill attaches to the acquired entity. In *Appeal of Borden*, the Board of Equalization ("BOE"), quoting a federal decision, stated:

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[4] *See* Merriam-Webster Dictionary online, https://www.merriam-webster.com/dictionary/goodwill and Accounting Standards Codification ("ASC") §§ 805-20-25-1 and 805-20-30-1.
[5] *See* Financial Accounting Standards Board, ("FASB") Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*.
[6] CCR § 25113(b)(5) requires taxpayers electing water's-edge to use US GAAP, or "the Franchise Tax Board may allow an alternative method of valuation of that member's business assets."
[7] The Company further represents an accurate comparison of net book values was performed as the Acquirer's goodwill was also correctly valued and considered when compared to Target's net book assets.
[8] *Pfleghar Hardware Specialty Co. v. Blair* (2d Cir. 1929) 30 F.2d 614, 616-17.

> Whether acquired by purchase or built up over a period of time, the advantage or benefit of goodwill makes possible the profitable operation of a business. Indeed, goodwill is so essential to the viable conduct of a business that it has been held to be inseparable from the business as a whole (*Grace Bros. v. Commissioner*, 173 F.2d 170, 175-176 (9th Cir. 1949).[9]

Thus, the value of the Target's goodwill was built up over time and was integral to the Target's business operations. It is therefore inseparable from the Target and must be attributed to it.

CONCLUSION

Goodwill recorded as a result of the Acquirer's acquisition of the Target should be included as a business asset of the Target for purposes of applying the "deemed water's-edge election" business asset test per R&TC section 25113(c)(2). Because the value of the Target's total business assets, including the goodwill, was larger than that of the Acquirer when the new unitary affiliate group was established on ******** * ****, the Acquirer was deemed to have made a water's-edge election.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Elizabeth Rodoni
Tax Counsel

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[9] *Appeal of Borden*, 77-SBE-007 (February 3, 1977).