Re: Water's-Edge Election

The Department has been requested to clarify its position with respect to several issues which have arisen as a result of the first time availability of the water's-edge election. These issues are as follows:

1. When will taxpayers on different fiscal years be able to elect water's-edge combination and how should such returns be filed?

The election is available to taxpayers whose income years begin on or after January 1, 1988. It is made on the initial return for the year and is valid only if all members of the water's-edge group make the election. Revenue and Taxation Code Section 25111. If taxpayers are on different fiscal years, the simultaneous election by all members of the water's-edge group is never possible. Also, in 1988 when the taxpayer whose year begins earliest becomes eligible to elect, other members of the water's-edge group are not yet eligible.

It should be noted that although the effective date problem for taxpayers with different years exists only for the 1988 income year, technically there is no real distinction to be made between 1988 and subsequent years as to the question presented. Consequently, for income years beginning on or after January 1, 1988, the following procedures shall be used by taxpayers which have different fiscal years which are members of the same water's-edge group.

Each member of the water's-edge group shall make the election upon its initial return for the income year. The election shall become effective as of the beginning of the income year of the last member of the group to file its return and election. The 60-month election period for each member of the group will run from the date that the election becomes effective, i.e., the beginning of the income year of the last member to elect. However, for purposes of filing a notice of nonrenewal of the election, the anniversary date of the contract shall be the later of the original due date of the return or the due date as extended as described in Regulation 25111(b)(2). For example, Corporation A whose year ends 12/31 and Corporation B whose year ends 6/30 are members of a water's-edge group. A files its election for 1988 on its return on October 15, 1989, the extended due date. A's election becomes effective as of July 1, 1988, the beginning of B's income year, and runs for 60 months therefrom. The anniversary date of A's contract is October 15.

NOTE: ((---)) = Indicates obsolete information.
Each taxpayer in the group shall calculate its tax on a worldwide basis for that portion of the year between the beginning of its income year and the beginning of the income year of the last member of the water's-edge group to make the election and on a water's-edge basis for the remainder of the income year. Thus, in the example given above, Corporation A will file its return for the 1988 income year apportioning its income to California on a worldwide basis for the period from January 1, 1988, through June 30, 1988, and on a water's-edge basis for the period from July 1, 1988, through December 31, 1988. The election fee shall be prorated as described in subsection (a)(5)(A) or (e)(2) of Regulation 25115 for that portion of the beginning and ending income year that the water's-edge election is in effect.

2. Will a target company acquired in a transaction for which Section 24519 (IRC 338) is elected retain its base period dividend history for purposes of the deduction permitted under Section 24411 and its historical payroll and property for purposes of calculating the fee base under Section 25115?

Yes. For most purposes the tax effect of a Section 24519 election is a liquidation and reincorporation of the target corporation in conjunction with a sale of its assets; however, because the business activities generally continue, it is appropriate in the context of the water's-edge election that the target corporation's historical payroll, property and dividend experience be considered for purposes of Sections 24411 and 25115. In all other situations involving corporate acquisition and disposition, the regulations under these sections provide for preservation and consideration of the corporation's base period experience.

3. Section 25111(b)(2) permits a termination of election in the event a taxpayer "ceases to be affiliated with any bank or corporation . . ." which would have been excluded from the combined group by a water's-edge election if the taxpayer itself conducts no business beyond the water's edge. The question has arisen as to whether in the above context "any" means "any single one" or "every." In other words, if a wholly domestic California taxpayer is affiliated with three foreign corporations and ceases to be affiliated with one of them, may it terminate its election, or must its affiliation with all three cease in order for the election to be terminated?
It is our opinion that a taxpayer may terminate its election only if its affiliations with all corporations doing business beyond the water's-edge cease. This interpretation is consistent with the legislative intent as described in the "Memorandum Accompanying the Proposed Conference Committee Report on SB 85 (Alquist) 5/1987-88" which speaks of the amendment to Section 25111(b) in terms of the taxpayer's becoming "solely domestic." Thus, if owing to changes in affiliation there is no longer any purpose served by the election, the taxpayer may terminate its election.

It should be noted that if there is a change in affiliation which results in a significant disadvantage to the taxpayer and which could not reasonably have been foreseen at the time the election was made, the taxpayer may request the Franchise Tax Board's permission to terminate the election.

4. The instructions for filing the domestic disclosure spreadsheet, specifically Form DDS-1, refer to provision of the "name and address of the bank or corporate parent of the California combined report group(s) . . ." Does this refer to the ultimate parent or to the parent of the group in California?

The ultimate parent. Regulation 25401(d) provides in paragraph (1) of subsection (f) "The list of affiliates includes all banks or corporations more than 20 percent of whose stock is owned or controlled directly or indirectly by the parent corporation of the group in which the California taxpayer is an affiliate." Paragraph (1) goes on to provide for a listing of all entities directly owned by the parent, all entities directly or indirectly owned by the parent which file federal tax returns and various summary information with respect to all other affiliated entities. If only the identify of the immediate parent of the California water's-edge group were requested, the information required under Regulation 25401(d) would not be complete.

5. Regulation 25115(d)(2)(A)(iii) in describing the property constructed by or for a taxpayer which may be used to reduce the election fee base states that "property is also constructed for a taxpayer when it is constructed by or for an affiliated bank or corporation." The question has arisen as to whether that provision has the effect of allowing one investment to lower each member of the group's fee base.
The new investment will lower the fee base of the taxpayer in whose property factor the property is included. See Regulation 25115(c)(1)(A). The clause quoted above must be read in the context of the entire paragraph, which defines "Section 70 property" and "Constructed by or for the taxpayer" as these terms are used in Revenue and Taxation Code Section 25115. The regulation at 25115(d)(2)(A)(ii) provides that property is constructed for the taxpayer if the taxpayer entered into an agreement for the construction or purchase of the property and subsequent to completion of construction, the taxpayer occupies and uses the substantial portion of the improved property. Immediately succeeding this definition, clause (iii) expands the definition of "constructed for the taxpayer" to encompass the situation where one member of the water's-edge group may rent property which was constructed by or for another member from that affiliate. Although the property is occupied by an affiliate, the primary owner may claim the reduction of its fee base. Only one member of the group will reduce its fee base by the investment and that is the member which includes the property in the numerator of its property factor.

6. The instructions for form FTB 2411 at E.2.b. on page 19 in defining Base Period Qualifying Dividends state that more than 50 percent of the voting stock of the payor must have been owned by a bank or corporation that was unitary in the base period years with a member of the water's-edge group. Is this correct?

No. The instructions are in error. There is no requirement that the owner of the stock have been unitary with a member of the water's-edge group during the base period years. See Regulation 24411(b)(3).

7. Section 25111(b)(4) provides that a taxpayer may terminate its water's-edge election if an audit results in a substantial modification to the composition of the water's-edge group as filed. What happens in the situation where an audit results in a nonelecting taxpayer being combined with a water's-edge group?

The election of the group is void. Section 25111(a) provides that a water's-edge election shall be made in the original return for the year and shall be effective only if every taxpayer which is a member of the group elects. No retroactive election is allowable under the express language of the statute. Therefore, because not every member of the water's-edge group elected on its original return for the
year, the election is not effective. In such a situation, the electors may file a claim for refund of the election fee.

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