



09.09.2016

FTB NOTICE 2016-02

SUBJECT: Treatment of Existing Water's-edge Elections After the Addition of Subdivision (b) of Revenue and Taxation Code Section 23101 Results in a Unitary Foreign Affiliate Becoming Subject to Tax in California

Issue

How will the Franchise Tax Board ("FTB") treat an otherwise-valid water's-edge election when a unitary foreign affiliate of the water's-edge combined reporting group becomes a taxpayer because it is doing business in California due to the addition of Revenue and Taxation Code section 23101, subdivision (b)?

Background

During the 2009-2010 third extra session, the California Legislature amended Revenue and Taxation Code¹ section 23101, adding subdivisions (b) through (d), operative for taxable years beginning on or after January 1, 2011. Subdivision (b) outlines additional circumstances that constitute doing business in this state. Corporations that are doing business in this state are subject to the franchise tax, i.e., they are taxpayers. (Rev. & Tax. Code, § 23151(a) et seq.) Consequently, a corporation that was not subject to the franchise tax (i.e., was not a taxpayer) could become subject to the franchise tax, (i.e., become a taxpayer) due to the addition of subdivision (b) of section 23101.

Section 25110 provides that a qualified taxpayer may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election. Section 25113 provides that a water's-edge election shall be effective only if every member of the self-assessed combined reporting group that is subject to taxation (i.e., all taxpayer members) make a water's-edge election. A unitary foreign affiliate of a water's-edge combined reporting group that, at the time of an election, was not doing business in this state under the provisions of section 23101(a) and thus, was not a taxpayer, could not make a water's-edge election for taxable years beginning before January 1, 2011 because that entity was not a taxpayer in California. However, beginning on January 1, 2011, if a unitary foreign affiliate is doing business in this state due solely to the addition of section 23101, subdivision (b), the foreign entity is subject to the franchise tax, and thus, is a taxpayer. Depending on whether a unitary foreign affiliate is a corporation whose income and apportionment factors would have been properly considered in computing the income of the taxpayers making a water's-edge election, the foreign affiliate may have been required by section 25113, subdivision (b), to make an election for the election to be effective. This Notice addresses the treatments the FTB will apply in situations where a unitary foreign affiliate of a water's-edge combined reporting group could not make an election at the time

¹ All unattributed statutory references are to the Revenue and Taxation Code.

of a water's-edge election because the affiliate was not subject to tax in California; but after the addition of section 23101, subdivision (b), the affiliate would have been required to make a water's-edge election for the election to remain effective.

Treatment of Elections

Section 25113 and the regulation thereunder address the effect on water's-edge elections resulting from changes in the composition of water's-edge combined reporting groups due to corporate events such as acquisitions, mergers, consolidations, or disaffiliations between electing and non-electing affiliates that occur after an election is made. However, neither the statute nor the regulation addresses the effect on an election due entirely to a change of law resulting in a change of status of a non-electing unitary foreign affiliate from non-taxpayer to taxpayer as outlined above.

The water's-edge election statute, and the regulation promulgated thereunder, were drafted to give effect to taxpayers' objective manifestations of intent to elect or terminate an election to the greatest extent possible. Therefore, consistent with this approach and subject to all of the conditions outlined below, the FTB will treat the existing water's-edge elections in the situations described below as follows:

- (1) When a unitary foreign affiliate has income derived from or attributable to sources within the United States as described in section 25110, subdivision (a)(2)(A)(i) ("United States Income") both before and after the beginning of a taxable year in which the affiliate becomes a taxpayer solely due to the addition of section 23101, subdivision (b), the deemed election provisions of section 25113, subdivision (b)(4) shall apply.
- (2) When a unitary foreign affiliate does not have United States Income either before or after the beginning of a taxable year in which the unitary foreign affiliate becomes a taxpayer solely due to the addition of section 23101, subdivision (b), the affiliate would never have been includable in the water's-edge combined report under section 25110(a)(2)(A)(i) despite its status as a taxpayer under section 23101, subdivision (b). However, in order to give effect to the objective intent of the taxpayers' unitary group to maintain an effective water's-edge election, the unitary foreign affiliate shall be deemed to have made an election as of the taxable year in which it became a taxpayer. The commencement date of the deemed water's-edge election shall be the same as the commencement date of the electing taxpayers of the existing water's-edge combined reporting group. In such circumstances, the foreign affiliate may be included in the group return of the existing water's-edge combined reporting group for administrative convenience.
- (3) When a unitary foreign affiliate does not have United States Income before, but has United States Income after, the beginning of a taxable year in which the affiliate becomes a taxpayer solely as a result of the addition of section 23101, subdivision (b), the unitary foreign affiliate will be deemed to have made an election as of the taxable year in which it becomes a taxpayer. The commencement date of the deemed water's-edge election shall be the same as the commencement date of the electing taxpayers of the existing water's-edge combined reporting group.

Conditions for Treatments in this Notice to Apply

The treatment of elections outlined above is limited to situations in which all of the following conditions apply:

- (A) a group of taxpayers made a valid water's-edge election before the date of this Notice, and
- (B) at the time the water's-edge election described in condition (A) was made, a foreign affiliate that was unitary with the electing water's-edge combined reporting group members could not make a water's-edge election because the affiliate was not subject to tax in California, and
- (C) the unitary relationship between the members of the water's-edge combined reporting group and the foreign affiliate remained continuously in effect between the time the valid water's-edge election was made and the time the unitary foreign affiliate became a taxpayer, and
- (D) the unitary foreign affiliate of the water's-edge combined reporting group became a taxpayer in a taxable year ending on or before December 31, 2016 due solely to the addition of subdivision (b) of section 23101, such that, had the foreign affiliate been a taxpayer member of a self-assessed combined reporting group at the time the water's-edge election described in condition (A) was made, the foreign affiliate would have been required by statute or regulation to make a water's-edge election in order for the water's-edge election to have been valid.

If all of these conditions are satisfied, the FTB will not seek to terminate the water's-edge election of the water's-edge combined reporting group that is unitary with the foreign affiliate that is now a taxpayer, but will apply the treatments outlined in paragraphs (1) through (3), above.

Except as provided in this Notice, all other provisions of law relating to the determination of the income derived from or attributable to sources within this state pursuant to a water's-edge election remain in full force and effect. The deemed election provisions of this Notice shall apply only to taxable years beginning within 84 months of the date of this Notice.

The principal author of this Notice is Norman Scott of the Franchise Tax Board Legal Division. For further information regarding this Notice, contact Mr. Scott at P. O. Box 1720, Rancho Cordova, CA 95741-1720.