



06.26.2019

FTB NOTICE 2019 - 02

SUBJECT: Extension of FTB Notice 2016-02 and FTB Notice 2017-04 - 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

PURPOSE

To extend the treatment set forth in FTB Notice 2016-02 and FTB Notice 2017-04 to include those foreign affiliates that become California taxpayers solely due to California Revenue and Taxation Code ("R&TC") section 23101, subdivision (b), in a taxable year beginning on or before December 31, 2020.

BACKGROUND:

R&TC section 25113 and the regulations thereunder address the effect on water's-edge elections arising from composition changes to the water's-edge combined reporting group due to mergers, acquisitions, consolidations, and disaffiliations. No statute or regulation addresses the effect on an election when the status of a non-electing unitary foreign affiliate changes from non-taxpayer to taxpayer due to the amendment of California's "doing business" standard that added R&TC section 23101, subdivision (b), in 2011.

On September 9, 2016, the Franchise Tax Board ("FTB") issued FTB Notice 2016-02 to provide administrative guidance on the treatment of a water's-edge election when a unitary foreign affiliate became a California taxpayer due to the enactment of R&TC section 23101(b). FTB Notice 2016-02 provides the background and legal framework to illustrate the issue at hand. On October 16, 2017, the FTB issued FTB Notice 2017-04, which effectively extended the treatment provided by FTB Notice 2016-02 until December 31, 2018. This Notice adheres to and incorporates by reference FTB Notice 2016-02 and FTB Notice 2017-04 in all respects, except the specific date constraints listed as conditions for FTB Notice 2016-02 and FTB Notice 2017-04 to apply. FTB Notice 2016-02 applies only to a group of taxpayers with a valid water's-edge election in effect on or before September 9, 2016, and only to unitary foreign affiliates that become taxpayers in California in a taxable year ending on or before December 31, 2016. Notice 2017-04 by its own terms only extends that treatment until December 31, 2018.

The FTB has also considered a legislative option to provide guidance regarding treatment of a taxpayer's water's edge election following the enactment of R&TC section 23101, subdivision (b).

Notice 2019-02 modifies the applicable taxable years set forth in FTB Notice 2016-02 and FTB Notice 2017-04 to include unitary foreign affiliates that become California taxpayers for taxable years beginning on or before December 31, 2020 solely due to the change in law per R&TC section 23101(b).

TREATMENT OF ELECTIONS

The FTB will apply the following treatments, as already stated in FTB Notice 2016-02 and FTB Notice 2017-04, and reiterated below:

- (1) When a unitary foreign affiliate has income derived from or attributable to sources within the United States as described in R&TC 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 R&TC section 23101, subdivision (b), the deemed election provisions of R&TC 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 R&TC section 23101, subdivision (b), the affiliate would never have been includable in the water's-edge combined report under R&TC section 25110(a)(2)(A)(i) despite its status as a taxpayer under R&TC 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 R&TC 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 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 FTB Notice 2019-02, and

- (B) at the time the existing water's-edge election 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 beginning on or before December 31, 2020 due solely to the addition of R&TC section 23101(b), 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 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 treatment of elections outlined in the Treatment of Elections section, paragraphs (1) through (3), above.

Except as provided in this Notice, FTB Notice 2016-02 and FTB Notice 2017-04, 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 shall remain in full force and effect.

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