Chapter 1 Introduction

Contents:

a. Introduction
b. History of Water's-Edge Legislation
c. Thinking About Water's-Edge: Federal international issues and the California system of allocation and apportionment
d. Auditing Water's-Edge Returns
e. The Future of Water's-Edge

a. Introduction

The Water's-Edge Manual (WEM) is designed and intended to aid auditors in the performance of water's-edge audits. It contains discussions of statutes, regulations, court decisions, department policies, and audit techniques.

As explained in FTB Notice 94-8, FTB manuals provide you with guidance but they are not authoritative. They should not be cited to support an audit position by either the auditor or the taxpayer. Do not use the WEM as a substitute for researching California and federal statutes, regulations, court decision, State Board of Equalization (SBE) and Offie of Tax Appeals (OTA) decisions that are pertinent to an audit issue. Instead, use the WEM as an initial step in understanding the issues. The WEM provides direction and is best used as a starting point for further research.

The department strongly encourages you to use creativity and initiative to develop additional techniques and improve existing ones.

The audit process is continually evolving due to:

- Statutory and regulatory revisions and enactments.
- Court, SBE, and OTA decisions.
- FTB Legal Rulings, Notices, and Technical Advice Memorandums.
- FTB new and revised policies and techniques.

To help ensure the continued usefulness of this manual, it is important that it be updated to reflect these changes. Any suggestions or corrections are welcome, and may be sent to the TRS Box or interoffice mail to Mail Stop F350.

1. What Is Water's-Edge?

During 1986 legislation was enacted in California to permit a "water's-edge election" to be made by certain taxpayers. (Stats. 1986, Chapter 660; R&TC §25110, et seq.) The water's-edge law was a significant change in the California Bank and Corporation Tax Law affecting multistate and multinational apportionment.

As will be discussed in more detail in WEM1(c), the water's-edge legislation was intended primarily to restrict California's application of the worldwide combined reporting method of determining income from California sources. The legislation makes it possible for a taxpayer filing on a worldwide basis to elect water's-edge treatment instead.

In other words, if a taxpayer would pay more tax under the worldwide method, it may choose to pay less by making a water's-edge election.

By making the choice, a taxpayer elects into a system of taxation which represents a blend of federal and state concepts of taxation. This blend of federal and state concepts is the subject of WEM1(d). Stated very broadly, under water's-edge the scope of combined reporting is limited to certain corporations (or portions of corporations) whose income is subjected to tax (directly or indirectly) for federal tax purposes. For example, an entity incorporated in the United States is generally subject to tax on all of its income by the U.S., and it is includible in a water's-edge combined report. In contrast, an entity incorporated in a foreign country, and which lacks certain connections with the United States, is not subjected to tax on its income by the U.S. In between these two extremes are entities for which the federal tax system and the water's-edge system have special rules (e.g., controlled foreign corporations with Subpart F income, corporations with income effectively connected with a U.S. trade or business, domestic international sales corporations). Refer to R&TC §25110(a)(1) and (2)

This correlation between the federal system and the water's-edge system is, however, subject to one extremely important limitation: the unitary business concept. The water's-edge rules do not override the unitary business concept, and they do not override the apportionment and allocation rules of the Uniform Division of Income for Tax Purposes Act (UDITPA). (R&TC §25120, et seq.)

The axiom that two corporations must be engaged in a unitary business in order to file a combined report applies under the water's-edge system. Reference is made to R&TC §25101 in R&TC §25110(a). What the

water's-edge rules do is to provide a further test (or set of tests) to determine what entities are includible in a combined report. In other words, under water's-edge, a corporation has to meet two tests to be included in a combined report: (1) it must be unitary with the electing water's-edge combined reporting group members, and (2) it must meet one of the specific water's-edge inclusion tests in R&TC §25110(a) (1) and (a) (2).

Perhaps the easiest way to think about the water's-edge combination is as a "carve-out." Determine all the members of the worldwide unitary group and carve-out the corporations which do not meet any of the inclusion requirements of R&TC §25110(a).

2. Water's-Edge – Election Requirement

Apart from federal international issues, the most significant feature of the water's-edge system is the water's-edge election. The provisions for making a water's-edge election were substantially changed with the enactment of Senate Bill (SB) 1061. (Stats. 2003, Chapter 633; R&TC §25113.) SB 1061 created new procedures, for taxable years beginning on or after January 1, 2003, pursuant to R&TC §25113, which replace the election by contract with a statutory election. See WEM 3.

The taxpayer's responsibilities under the water's-edge election include an obligation to be subject to the water's-edge rules and to forego the right to file a worldwide combined report for seven years (84 months). This seven year term may be terminated under certain circumstances. It is subject to detailed rules concerning when and how it starts, and when and how the termination is initiated. The water's-edge election requirements are covered in WEM 3.

3. Water's-Edge Dividend Deduction and Interest Offset

The last feature of the water's-edge formula deserving a brief mention is the deduction for dividends and accompanying interest offset applicable to U.S. based multinational corporations. A foreign subsidiary of a U.S. corporation is generally excluded from the combined report. But dividends received by the U.S. corporation from an excluded subsidiary are still taxable income under both U.S. and California tax concepts. In a worldwide combination setting such dividends may qualify for elimination in computing worldwide business income subject to apportionment, to the extent that they are paid out of earnings and profits attributable to the unitary business. In the water's-edge context, this elimination is conditioned on the foreign subsidiary being included in the California combined report, and such

condition is obviously not met where the subsidiary is excluded under a water's-edge election. (R&TC §25106.)

The water's-edge rules provide for a formula-based deduction to apply to dividends received from a foreign subsidiary. As a general rule, a deduction for 75 percent of the dividends is allowed. The dividend deduction is reduced, however, to the extent the water's-edge group has incurred interest expense for the purpose of making investments in foreign subsidiaries. (R&TC §24344(c).) This "interest offset" to the dividend deduction is defined by means of extensive California regulations based in large part on comparable federal rules for determining whether interest expense is U.S. or foreign "source" expense for federal tax purposes. (R&TC §24344(c).) The dividend deduction is covered in WEM 9 and the foreign investment interest offset are discussed in WEM 10.

4. Summary

In addition to UDITPA rules, water's-edge filing requires you to:

- Determine the corporations required to be included in the water's-edge combined report
- Adapt and apply federal international tax rules
- Apply election, termination, and re-election rules
- Compute the amounts that may qualify for dividend elimination and dividend deduction
- Compute the foreign investment interest offset

Each of these key aspects of the water's-edge rules briefly discussed above is the subject of one or more chapters in the text which follows.

b. History of Water's-Edge Legislation

From the late 1970's to the mid-1990's, California, along with other combined reporting states, sought to extend combined reporting to multinational unitary groups by requiring these groups to include both their domestic and foreign affiliates. Constitutional challenges to this imposition of worldwide combined reporting were made under Foreign Commerce Clause. As articulated in *Japan Line, Ltd. v. County of Los Angeles (1979)* 441 U.S. 434, a state taxing scheme can be struck down under the Foreign Commerce Clause if it either: (1) Made the risk of international multiple taxation inevitable; or (2) if such taxation prevents the United States government from "speaking with one voice" in international tax affairs. In 1983, the U.S. Supreme Court decided *Container Corp. of America v. Franchise Tax Board* (1983) 463 U.S. 159, holding, in relevant part, that California's use of worldwide combined reporting did not violate

the tenets of the Foreign Commerce Clause. In *Container*, the parent company in the unitary group was domiciled within the United States.

In the aftermath of *Container* (supra), the multinationals and the foreign governments prevailed on the Reagan Administration to undertake an active role in the resolution of the controversy. In late 1983 Treasury Secretary Donald Regan established a "Working Group" of representatives of the states and the multinationals, to study the problem and propose solutions. Governor George Deukmejian of California was a member of the Working Group. The Working Group appointed a Task Force to assist it. The Task Force held discussions and conducted hearings, and, in May, 1984, released a report drafted on its behalf by U.S. Treasury Department staff members. Further reference is noted in Tax Notes, dated May 7, 1984, p. 637. The Task Force developed six options for restricting application of worldwide combined reporting, but Treasury Secretary Regan was not successful in getting the multinationals and the states to agree that one of the options was preferable to the others. The Working Group's primary achievement was that it had definitely determined that the states were willing to abandon worldwide combination if the U.S.-based multinationals were willing to allow apportionment of foreign dividends and inclusion of "80/20" companies (U.S.-based corporations with 80 percent of their activities conducted in foreign countries). Treasury Secretary Regan announced that a compromise of this fundamental disagreement would be "worked out in the state legislatures." ("Unitary Method Working Group Agrees to Disagree," Tax Notes, May 7, 1984, p. 571.)

Almost immediately following the Working Group's report a number of states enacted water's-edge legislation. In California, after many years of failed legislation, in 1986, the proponents of water's-edge finally broke through, enacting Senate Bill 85, Stats. 1986, Chapter 660.

Significant water's-edge reform legislation was passed again in 1993, effective for income years beginning on or after January 1, 1994. Those changes were:

- Rescinded all remaining contract periods for water's-edge contracts beginning prior to January 1, 1994. (Former R&TC §25111.1)
- Repealed the annual election fee (Former R&TC §25115)
- Repealed the spreadsheet filing requirement
- Repealed the FTB's ability to disregard an election for specified reasons, and
- Extended the election period from five years to seven years (eighty-four months)

c. Thinking about Water's-Edge? Federal International Tax Issues and The California System of Allocation and Apportionment

As discussed briefly in the introduction of this chapter, there is a certain correlation of the water's-edge system with the U.S. federal system of income taxation. In broad terms, water's-edge combined reporting is coextensive with the application of the federal income tax on U.S. corporations and foreign corporations engaged in business in the U.S. However, federal tax jurisdiction has a very different foundation from state tax jurisdiction, and the details of how the federal and California systems work have important implications.

As discussed in other chapters in the WEM, federal income tax jurisdiction is defined by statutory law. It is not subject to the U.S. constitutional limitations which apply to state income taxation. As to U.S. incorporated entities, for example, the United States government asserts jurisdiction to tax all of their income, regardless of whether its source is within or without the United States (IRC §11). California, on the other hand, is constrained to tax only the income of such entities which has its source in this state. This rule is expressed in R&TC §25101. However, in addition to that statute, California's jurisdiction to tax domiciliaries is limited by the Due Process and Commerce Clauses of the U.S. constitution. (*Mobil Oil Corporation v. Commission of Taxes of Vermont*, 445 U.S. 425 (1980); *ASARCO, Inc., v. Idaho State Tax Commission*, 458 U.S. 307 (1982).)

This different jurisdictional basis for taxation is reflected in numerous differences in the details of how the federal tax system operates in contrast to the state system. In the case of the water's-edge carve-out, the scope of the California combined report may bear a strong resemblance to the federal consolidated tax return. Both include commonly controlled entities incorporated in the United States. For Federal requirements in a federal consolidated return, refer to IRC §1501. For California requirements, refer to R&TC §25110(a)(1)(C). However, all of the income of the federal consolidated group is taxable by the United States, including that derived from sources outside the United States in accordance with IRC §§11,1502,1503. California, once again, may only tax value -- income -- earned within its borders. Where the taxpayer's business operates across state borders, then the income must be apportioned among the states. Implicit in this apportionment scheme is the unitary business concept: it is the income of a unitary business which must be apportioned. If two discrete businesses are conducted in two different states, then there is no unitary business and no apportionment requirement. In that case each state may only tax the income of the one business earning income within its

borders; it would have no jurisdiction to tax the earnings of the other business. (*Mobil*, supra.)

Example 1

Corporation A and Corporation B are affiliated and eligible to file a federal consolidated tax return. A engages in the business of manufacturing and distributing machines in California and throughout the world. B engages in the business of franchising restaurants in the state of Texas. A and B are not engaged in a unitary business.

Although A and B may file a federal consolidated tax return, such would not be coextensive with A's California water's-edge combined report. B may not be included in that combined report because it is not engaged in a unitary business with A. Moreover, California may only tax the income of A which is derived from sources within California.

The second broad area where it is important to understand the distinctions between the federal and the water's-edge systems is in the manner of dealing with international operations and transactions. WEM 4, provides an overview of the federal system taken as a whole, and subsequent chapters in this text will consider the details of specific federal issues which will be important in the preparation and audit of water's-edge tax returns. For now, however, it is helpful to simply consider the basic differences in purpose and scope of the federal and the water's-edge rules.

As mentioned above, the U.S. government asserts jurisdiction to tax all of the income of a U.S.-incorporated entity, regardless of source. In essence, the United States taxes the "worldwide income" of such corporations. But this is something which is quite different from the concept of "worldwide income" that occurs in the context of worldwide combined reporting. In the federal conception, "worldwide income" is all of the income of the one corporation; it has nothing to do with the income of the foreign subsidiaries of that corporation.

Example 2

Corporation A engages in the business of manufacturing and distributing machines in California and throughout the world. Its subsidiary, Corporation B, is the sole distributor of Corporation A's products in West Germany, and was formed under the laws of that country. Corporations A and B are engaged in a unitary business.

In filing a worldwide combined report in California, the "worldwide income" subject to apportionment to determine the California source income of A includes the earnings of both A and B. But, for federal purposes, the "worldwide income" of A is simply A's separate accounting income. Although that may include dividends and receipts from the sale of products to B, B's income is not included in the measure of A's federal tax liability.

Although the federal government asserts jurisdiction to tax the "worldwide income" of a U.S. corporation, it distinguishes between the "U.S. source" and "foreign source" income of such. (IRC §§861-865.) This is because a principal goal of the U.S. tax system is to harmonize international trade and other economic relationships by avoiding international double taxation. Where a U.S. corporation earns income in a foreign country, that foreign country may well assert jurisdiction to tax the income because it is sourced in that country. Since the U.S. asserts jurisdiction to tax the same income because the corporation generating the income is domiciled in the U.S., double taxation will arise absent some relief provision. In the U.S., such relief is afforded by means of the "foreign tax credit."(IRC §§901 and 902.)

Example 3

Corporation A, incorporated in the United States, conducts its business in the United States and in Canada. It earns $100 in the U.S. and $50 in Canada, for total earnings of $150. The total earnings are subject to tax by the U.S., but that tax is subject to a credit for taxes paid to Canada on the $50 of Canadian source income.

These source of income, and foreign tax credit rules will be described in more detail in WEM 4. The important thing is that while taxing the totality of a corporation's income and providing for a foreign tax credit are central to the federal system, there is no direct application in the water's-edge system.

Two observations about the California system may serve to emphasize this point, and to explain the reason for the distinction.

First, California has no provision for allowing a credit for taxes paid to foreign jurisdictions. This is because there is no need for one. The reason that the federal government needs to allow a credit is to avoid international double taxation. The reason that there is a danger of international double taxation is that the federal government asserts jurisdiction to tax without regard to the source of income. On the other hand, California only taxes income sourced in California, and therefore it has no need to redress international double taxation, because under sourcing principles there is no double taxation.

The second observation is that the federal source of income concept is generally irrelevant to California water's-edge tax returns, in that it has different connotations. California may only tax California source income, and such is determined under the apportionment and allocation rules of the Uniform Division of Income for Tax Purposes Act (UDITPA). (R&TC §25120, et seq.) But the geographic source of income for federal purposes is determined under quite a different scheme under IRC §§861 through 865. The California and UDITPA geographic sourcing methods emphasize formula apportionment; the federal method emphasizes an analysis of the transactions which result in the realization of income. The federal and California methodologies for determining the source for income are different from one another.

d. Auditing Water's-Edge Returns

Thus far in this introductory chapter, we have discussed the water's-edge law in terms of its general outline and key features, its history, and its relationship to the federal international tax system. What follows is a brief discussion of auditing water's-edge tax returns.

The following observations are illustrative of the areas confronted when conducting a water's-edge audit.

- A water's-edge audit is not the same as a transfer pricing examination, which is referred to as an "IRC section 482" examination.
- Water's-edge tax returns must reflect combined reports of corporations engaged in a unitary business. Depending on the tax year, they employ a three-factor apportionment formula (reflecting a property factor, a payroll factor and a sales factor) or single sales factor apportionment formula. Business income is subject to apportionment; nonbusiness income is allocable. The foreign investment interest offset applies. Income taxes are not deductible. MACRS is not applicable. These issues are generally present in audits involving the worldwide combined reporting methodology and may be present in a water's-edge tax return.
- Expert knowledge of federal international issues, is not required to audit water's-edge returns. However, a general understanding of the federal international provisions are necessary if audits are to prove effective.
- Unique water's-edge issues, especially those having to do with federal international issues, are likely to be hyper-technical.
- IRC §482 isn't the only significant adjustment. Subpart F, for example, could be very significant in some cases, and Subpart F adjustments can bear a very close relationship to a potential IRC §482 adjustment.

Although, Subpart F could be a significant adjustment or ECI (income effectively connected with a U.S. trade or business), these issues could also be very insignificant. It is necessary to be flexible in the audit techniques applied.

e. The Future of Water's-Edge

The most significant challenge to the water's-edge system was the challenge to mandatory worldwide combined reporting. However, in June 1994 the U.S. Supreme Court issued decisions upholding worldwide combination for both foreign-based and domestic-based multinationals. (*Barclays Bank Plc v. Franchise Tax Board; Colgate-Palmolive Co. v. Franchise Tax Board*, 114 S.Ct. 2268 (1994), aff'g 10 Cal.App. 4th 1742 (3d Dist., 1992) and 10 Cal.App. 4th 1768 (3d Dist., 1992).)

In spite of the Supreme Court's decision in *Barclays*, California is unlikely to repeal water's-edge and return to mandatory worldwide combined reporting. In fact, the water's-edge election has become seemingly embedded in the California tax system at a time when use of separate accounting for transactions with foreign affiliates has become the subject of much controversy at the federal level.