

Chapter 3 Water's-Edge Election

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

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a. Introduction

For taxable years beginning on or after January 1, 2003, the manner of making a water's-edge election changed from a contract (R&TC §25111) to a statutory election (R&TC §25113). There is a significant difference between water's-edge elections made by contract and those made by statutory elections. This chapter assists you in understanding the interaction between R&TC §25111 and R&TC §25113.

Depending on the years involved, making the water's-edge election is governed by:

- R&TC §25111 – For tax years 1988 through 2002
- R&TC §25113 – For tax years beginning on or after January 1, 2003

1. Pre-2003 years

From 1988 to 2002, R&TC §25111 and CCR §25111 provide the rules for:

- Making a water's-edge election as provided under R&TC §25110. For those years, taxpayers elected water's-edge by attaching a contract, form FTB 100-WE, to the original tax return.
- Terminating a water's-edge election.
- Renewing the contract period on the anniversary date.

For water's-edge elections, deemed elections, changes in affiliation, terminations, and non-renewal issues effective for taxable years beginning prior to January 1, 2003, see R&TC §25111 and CCR §25111.

2. 2003 year and thereafter

In 2003, the Legislature (SB 1061, Stats. 2003, Ch. 633) enacted R&TC §25113, which makes substantial changes to the water's-edge provisions.

For taxable years beginning on or after January 1, 2003, R&TC §25113 governs the manner of making a water's-edge election as provided under R&TC §25110. It also governs the manner in which the water's-edge election may be terminated. The following are the most important provisions of R&TC §25113:

- Replaces the contract with a statutory election.
- Keeps the initial election period at 84 months (seven-years).
- Requires that the election be made on a timely filed original return.
- Provides that the Franchise Tax Board may accept other objective evidence that a water's-edge election is intended (similar to the substantial performance of CCR §25111).
- Reforms the acquisition rules, so that a taxpayer's water's-edge election would no longer automatically apply to other non-electing affiliates with which it becomes unitary.
- Provides that taxpayers that have valid elections for taxable years beginning before January 1, 2003, will continue to file on a water's-edge basis.

- Provides that water's-edge elections entered prior to 2003 are now governed by R&TC §25113.
- Makes the "anniversary date" and the "notice of non-renewal" provisions of R&TC §25111 inoperative for taxable years beginning on or after January 1, 2003.
- Describes the manner in which a taxpayer may terminate the water's-edge election with and without the Franchise Tax Board's consent.
- Describes the manner in which a taxpayer may re-elect water's-edge after having terminated the election with and without the Franchise Tax Board's consent.
- Provides that the commencement (start) date of an election made prior to 2003 under R&TC §25111 continues to be treated as the commencement date of the water's-edge election period for purposes of applying R&TC §25113.

Corporations with valid elections for taxable years beginning before January 1, 2003, continue to file on a water's-edge basis and are deemed to have elected under the new statute (R&TC §25113) for taxable years beginning on or after January 1, 2003. However, the original commencement (start) date, as elected under R&TC §25111, remains in effect. (R&TC §25113(f).) For examples of the applications of the transitional rules, see CCR §25113(c)(6).

b. Definitions

To understand the water's-edge election issues, the following definitions are relevant:

1. Corporation

The term "corporation" applies to all entities described as corporations, including banks, under R&TC §23038. (CCR § 25110(b)(1).)

2. Parent Corporation

A "parent corporation" of the taxpayer is a corporation that owns or constructively owns stock possessing more than 50 percent of the voting power of the taxpayer as determined under R&TC §25105, subdivisions (e) and (f). (R&TC §25113(b)(3); CCR §25113(b)(6).)

3. Taxpayer

"Taxpayer" is an individual corporation subject to the California Corporation Tax Law. It does not mean the water's-edge group or all the members of the

water's-edge group that are required to file under the California Corporation Tax Law. (CCR §25113(b)(11).)

4. Qualified Taxpayers

A "qualified taxpayer" for purposes of the water's-edge election is a corporation which:

- A. Files with the state tax return on which the election is made and consents to:
 - The taking of depositions, and
 - The acceptance of subpoenas duces tecum. (R&TC §25110(b)(2)(A).)
- B. Agrees to business income treatment of dividends from:
 - A. More than 50 percent owned (directly or indirectly) foreign subsidiaries that are in the same general line of business, or
 - B. Regardless of the 50 percent ownership requirement, a bank or corporation which is a significant source of supply to or a purchaser from the unitary business. (R&TC §25110(b)(2)(B).)

5. Original Return

An "original return" is the last return filed on or before the due date (including extensions), regardless of the form on which it is filed. A return filed after the due date (taking extensions into account) may be an original return, if no other return has been filed, but it would not be a timely filed, original return. (CCR §25113(b)(2).) For examples of what constitutes an original return, see CCR §25113(c)(4).

6. Water's-Edge Group

The "water's-edge group" means all corporations or other entities whose income and apportionment factors are considered under R&TC §25110 in computing the income of the individual taxpayer for the current taxable year which is derived from or attributable to sources within this state. (CCR §§25110(b)(6) and 25113(b)(1).) See WEM 2 for a complete discussion of the entities required to be included in the water's-edge combined report.

7. Group Return

A water's-edge "group return" is a single return filed on behalf of eligible electing taxpayer members of a combined reporting group included on the

electing key corporation's Schedule R-7 filed with Form 100W, California Corporation Franchise or Income Tax Return – Water's-Edge Filers. (R&TC §25113(d)(2) and CCR §25106.5(b)(13).)

8. Combined Reporting Group

A water's-edge "combined reporting group" refers to those corporations whose income and apportionment factors are permitted or required in computing the income of the individual taxpayer that is derived from or attributable to sources within this state, taking into account a valid water's-edge election. (R&TC §25113(d)(1) and CCR §25106.5(b)(3).)

9. Unitary Affiliated Group

The phrase "unitary affiliated group" refers to all of those corporations that would constitute a unitary group if a water's-edge election were not made. (R&TC §25113(c)(6)(B) and CCR §25113(b)(7).)

10. New Unitary Affiliated Group

The phrase "new unitary affiliated group" refers to a unitary affiliated 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 affiliated group. (R&TC §25113(c)(6)(C) and CCR §25113(b)(8).)

11. Self-Assessed Combined Reporting Group

The phrase "self-assessed combined reporting group" refers to the group of corporations whose income and apportionment factors are reflected in a combined report of a timely filed return, taking into account the effects of a purported water's-edge election, whether or not the membership of the corporations in that combined report was correctly computed. (R&TC §25113(d)(3).)

12. Good Cause

The term good cause has the same meaning as specified in Treasury Regulation §1.1502-75(c). For water's-edge taxpayers, this term generally refers to substantial changes to the water's-edge law sections (e.g., R&TC §25110, §25113) which adversely affect the tax liability of the water's-edge group. (R&TC §25113(c)(10)(A) and CCR §25113(b)(12).)

c. Taxpayers Covered By the Election

All affiliated banks or corporations engaged in a single unitary business must file on the same basis. Accordingly, if a water's-edge election is made, all taxpayers in the unitary business must file on a water's-edge basis. Alternatively, if there is no water's-edge election, all taxpayers in the unitary business must file on a worldwide basis.

Making a water's-edge election in no way affects the unitary relationships between the banks or corporations.

d. Making the Election

To make a water's-edge election as provided under R&TC §25110, an entity must meet the following two conditions:

1. Qualifications

- Be a corporation as described in R&TC §23038.
- Be subject to California franchise or income tax.
- Be a qualified taxpayer (see WEM 3.1, section b for definition of a qualified taxpayer). (R&TC §25110(a).)

2. Filing

- Computes its tax on a water's-edge basis.
- Uses Form 100W, California Corporation Franchise or Income Tax Return-Water's-Edge Filers.
- Files its original return, Form 100W, timely. See CCR §25113(c)(4) for examples of returns timely filed. R&TC §25113 requires that the statutory water's-edge election be made on a timely filed original return. California tax law does not allow a taxpayer to elect water's-edge through an amended return. The original return is the last return filed on or before the due date or extended due date. If no return is filed by the extended due date, then the original return will be the first return filed after that date. (CCR §25111(e)(1).)

The taxpayer attaches Form 100-WE, Water's-Edge Election, to the timely filed original return (Form 100W) for the year of the election. (For taxable years beginning on or after January 1, 2003, the language on this form changed from contract to statutory language.) (R&TC §25113 and CCR §23113(c).)

The water's-edge election is effective only if made by every member of the water's-edge group. (R&TC §25113(b).)

A water's-edge election must be for an initial term of 84 consecutive months (R&TC §25113(c)(9)), and it remains in effect thereafter, year after year, until the taxpayer chooses to timely terminate it. (R&TC §25113(c)(12).)

e. Commencement (Start) Date

The commencement date of a water's-edge election is the first date of the period for which the election is made.

For water's-edge elections entered prior to January 1, 2003, the commencement date of the water's-edge election is the beginning of the taxable year covered by the most recent anniversary date. See CCR §25113(c)(6) for examples relating to the commencement date.

As provided by CCR §25113(d), the commencement date is important in determining the number of months that a water's-edge election has been in effect. If the water's-edge election has been in effect for:

- **Less than 84 months –**
 - California tax laws require the taxpayer to continue filing under water's-edge for the remaining balance of the election period.
 - If the taxpayer wishes to terminate its water's-edge election, it must obtain the Franchise Tax Board's consent by timely filing Form 1117, Request to Terminate Water's-Edge Election, and demonstrate good cause. See WEM 3.2, Terminations and Re-Elections.

- **More than 84 months –**
 - The taxpayer continues to file under water's-edge on a year-by-year basis without being subjected to a new 84-month election period.
 - The taxpayer may terminate the election without the Franchise Tax Board's consent. To terminate the water's-edge election, the taxpayer must:
 - Timely file an original return on a worldwide basis
 - Use Form 100 rather than Form 100W
 - Attach a statement to the timely filed original return indicating that the water's-edge election is being terminated. (CCR §25113(d).)

The effective termination date would be the last day of the taxable year immediately preceding the worldwide filing. See WEM 3.2, Terminations and Re-Elections

f. Validity of Election

If it is unclear whether the taxpayer elected water's-edge treatment on its original timely filed return, the auditor must verify the validity of the election.

The term "substantial performance" means that even though the taxpayer did not comply with all of the statutory or procedural requirements, the taxpayer computed the tax consistent with a water's-edge election, and the original timely filed return contains "objective evidence" to support the conclusion that the taxpayer intended to elect water's-edge. (CCR §25111(a)(2)(A).)

The term "objective evidence" refers to any water's-edge form substantially completed or other written statement attached to the original timely filed return supporting the taxpayer's intention to make a water's-edge election for that year.

R&TC §25113 codified the "substantial performance" concept. R&TC §25113 provides that the FTB may accept other objective evidence that a water's-edge election is intended (similar to the substantial performance of CCR §25111). If the taxpayer substantially performs the requirements for entering into a water's-edge election, then the election is valid and the taxpayer is bound by the terms of the water's-edge election.

To evaluate whether the taxpayer has made a valid water's-edge election, consider the following:

- **The taxpayer computed the tax consistent with a water's-edge election** – Use your judgment to determine whether this condition has been met. Evaluate all of the facts and circumstances to determine whether the taxpayer was attempting to compute its California tax liability consistent with a water's-edge election, or whether the filing was based on some other theory. For example, a taxpayer would not be deemed to meet this requirement if the tax return reflects that the taxpayer excluded some foreign affiliates but included others and disregarded water's-edge provisions such as partial inclusion and the foreign dividend deduction.

- **The original timely filed return contains objective evidence to support the conclusion that the taxpayer intended to make the water's-edge election** – Essentially, “objective evidence” exists if there is evidence to indicate that the taxpayer intended to make a water's-edge election for that year. The objective evidence must be included with the original timely filed return for the year of the election. A filing position taken in previous years is not objective evidence that the taxpayer intended to make a new water's-edge election in a subsequent year. Furthermore, because the election must be made on a timely filed original return, actions taken by the taxpayer after the original return has been filed cannot be considered objective evidence of the taxpayer’s intent on the original return.

Objective evidence exists if the taxpayer:

- Filed using Form 100W (S Corporations file form 100S), California Corporation Franchise or Income Tax Return – Water's-Edge Filers.
- Attached to its original timely filed return one or more substantially completed water's-edge forms. (e.g., Forms 100-WE, 1115, 1116, 2411, 2416, 2424.)
- Attached a statement to the original timely filed return stating its intent to make a water's-edge election.

g. Election Made on a Group Return

A water's-edge election made on a group return of a self-assessed combined reporting group constitutes an election by each taxpayer member included in that group return, unless a member files a separate return on which no election is made and is not bound by the common parent's election as explained in WEM 3.1, section h. (R&TC §25113(b)(1).)

h. Common Parent Elections

A taxpayer that fails to make an election on its own timely filed original return is deemed to have elected if either of the following two conditions applies:

- A. It has a parent corporation that:
 1. Is an electing taxpayer
 2. Filed a timely original return

3. Included the income and apportionment factors of the non-electing taxpayer in the self-assessed combined reporting group, including a group return (R&TC §25113(b)(2)(A)).

B. Filed a notification of election (Form 100-WE – Water's-Edge Election or other "objective evidence") signed by an officer or other authorized agent of either the parent of the non-electing taxpayer or another corporation with authority to bind the non-electing taxpayer to the election. (R&TC §25113(b)(2)(B)), CCR §25113(b)(13).) See CCR §25113(c)(2)(A) examples 1, 2, 3, and 4 for illustrations of common parent elections.

i. Election Allowed Along Unitary Business Lines

A taxpayer or an affiliated group of taxpayers engaged in more than one unitary business may make a water's-edge election with respect to any one or more of its businesses. It need not elect for all of its businesses. (R&TC §25113(b)(5) and CCR §25113(f)(1).) Each unitary business filing on a water's-edge basis must file a separate election.

Example

Corporation A, a conglomerate, owns three nonunitary corporations and their subsidiaries, Corporations B, C, and D. Corporations B, C and D were engaged in the business of manufacturing aerospace items, growing tobacco products, and producing and distributing motion pictures, respectively. There are three unitary groups:

- Corporation B, its unitary subsidiaries, and A's aerospace division
- Corporation C, its unitary subsidiaries, and A's tobacco products division
- Corporation D, its unitary subsidiaries, and A's motion picture division

Corporation A may make water's-edge elections with respect to the tobacco products business and motion picture business, but may continue worldwide combined reporting for the aerospace business. The fact that Corporation A did not elect to file on a water's-edge basis for the aerospace business does not nullify the elections for its other unitary businesses.

j. Locating and Verifying Water's-Edge Election Information

1. How to Locate Water's-Edge Election Information

Water's-edge election information is posted to the Business Entities Tax System (BETS). On BETS, the water's-edge information is shown under conversation ((****)) (aka water's-edge shell).

The water's-edge shell shows:

- Beginning and ending dates of the election
- Anniversary date – This field is disabled
- Status Code. The status code is one of the following:
 - **Unprocessed** – This is the default code when the water's-edge shell is created in BETS. Conversation ((****)) is populated when the return is identified as water's-edge (e.g., the taxpayer files Form 100W, California Corporation Franchise or Income Tax Return – Water's-Edge Filers and attaches the election form FTB 100-WE). Upon the creation of the water's-edge shell, it puts all the water's-edge flags in other conversations in BETS. Most elections in BETS ((****)) have this default code.
 - **Processed** – This code merely indicates that a member of the Technical Resource Section performed a cursory review of the election based on the information available in the return, and deemed the election to be valid.
 - **Transfer** – The water's-edge group changed its key corporation. However, the water's-edge election remains in effect, but it is now shown under a new key corporation.
 - **Invalid** – Audit invalidates the water's-edge election. This code removes all water's-edge flags from other conversations in BETS.
 - **No Contract** – Water's-edge shells created in error. This code removes all water's-edge flags from other conversations in BETS. Once a shell is created in BETS, it cannot be deleted.
 - **Nonrenewal** – The taxpayer filed form FTB 1116, Notice of Nonrenewal of Water's-Edge Contract. Form FTB 1116 is now obsolete.

- o **Termination** – The taxpayer terminated the water's-edge election with or without the Franchise Tax Board's consent. See WEM Section 3.2.

It is your responsibility to determine whether the taxpayer's water's-edge election is valid based on factual findings at audit.

2. Verify That the Election Has Been Posted On BETS

Whenever you scope or otherwise review a water's-edge return, check the Business Entities Tax System (BETS), conversation ((***)), to verify that the water's-edge election is on the BETS system.

It is essential that you update BETS to reflect the water's-edge election because this information is critical for subsequent years.

If you identify a valid water's-edge election, and it has not yet been posted to BETS ((***)), you should provide the election information to the individual in the Technical Resource Section responsible for updating the BETS conversation.

3. Identifying Water's-Edge Elections

Verify the validity of the water's-edge election when scoping returns for audit. (WEM 3.1, section f – Validity of Election.) You should take the following steps:

- Check to see if a water's-edge election is attached to the return. If the election FTB 100-WE is attached, the election is valid unless the election was not made on an original timely filed return, or unless there are inconsistent filings that are material enough to cause the group to fail the substantial performance test.
- Verify that the taxpayer made the election on an original timely filed return (for taxable years beginning on or after January 1, 2003).
- Check BETS conversation ((***)) to verify that the election has been posted.
- Identify all the taxpayers included in the election and verify that they have either filed a group return or are properly included in a common parent election.

- Determine whether the return represents the first year of the intended election or whether the election was made in a prior year. It may be necessary to request prior year returns to make this determination.
- If the taxpayer made the election in a prior year, review any prior year audit activity. If the election has already been verified and the BETS conversation ((***) is updated, no further verification is needed. If the prior year election was not verified or if the current year is the first year of the election, determine whether the election is valid.

4. What To Do When the Election Is Invalid

If you determine that the taxpayer has not complied with or substantially performed the election requirements, it is critical that you notify the taxpayer in writing regarding the invalid election as soon as possible. This requirement applies regardless of whether invalidating the election will produce a material tax effect for the year currently under review. An invalid water's-edge election is often a multi-year problem, and taxpayers must be notified of any problems as soon as possible so that they do not continue to file on an incorrect basis.

If the election problem is identified on a return that has not been selected for audit, refer the return to the individual in the Technical Resource Section responsible for updating the BETS conversation. That individual will contact the taxpayer regarding the invalidation and will ask the taxpayer to file an amended return(s) on a worldwide basis. The individual in the Technical Resource Section will update BETS conversation ((***) to show a status code of "invalid."

As stated above, invalidating a water's-edge election may have multi-year effects, and it may also affect taxpayer's tax planning and return filing positions for subsequent years. Therefore, a proposal to invalidate a water's-edge election should be taken very seriously. If you need assistance to evaluate whether the taxpayer's fact pattern constitutes substantial performance, consult with a specialist in the Technical Resource Section.

k. Election Period

1. Term

Each taxpayer must file returns on a water's-edge basis for an initial period of 84 consecutive months (seven years). R&TC §25113 does not impose an automatic renewal of the election. Instead, after the initial 84-month election period, the water's-edge election remains in effect thereafter, year

by year, until the taxpayer chooses to timely terminate it. (R&TC §25113(c)(12).)

2. Short Period Return

R&TC §25113 requires the taxpayer to elect water's-edge for an initial period of 84 consecutive months. This period cannot be shortened even if the taxpayer files short period returns. It is possible that the filing of a short period return causes the initial 84 months water's-edge election to end in mid-taxable year. If so,

- The taxpayer continues to file under water's-edge for the full year; or
- The taxpayer may terminate the election at the end of the 84-month period. However, if it elects out in mid-year, it will be required to:
 - File a timely original return
 - Use a hybrid water's-edge/worldwide basis to compute the tax, and
 - Attach a statement to the return explaining that it is electing out of the water's-edge election.

Example

The taxpayer elects to file on a water's-edge basis beginning on April 1, 2003 for a fiscal year ending March 31, 2004. The initial 84-month election period ends on March 31, 2010. The taxpayer changes accounting periods from a March 31 year-end to a December 31 year-end in 2006. The taxpayer elects out in mid-year, March 31, 2010.

The election period is for 84 months and not 7 taxable years. For the taxable year ending December 31, 2010, the taxpayer must file on a hybrid water's-edge/worldwide combination method. This is done by using the water's-edge method for the first 3 months and a worldwide combination method for the last 9 months of the taxable year. The taxpayer needs to attach a statement to its tax return explaining that it terminated the water's-edge election as of March 31, 2010. See WEM 3.2.

3. Different Fiscal Years

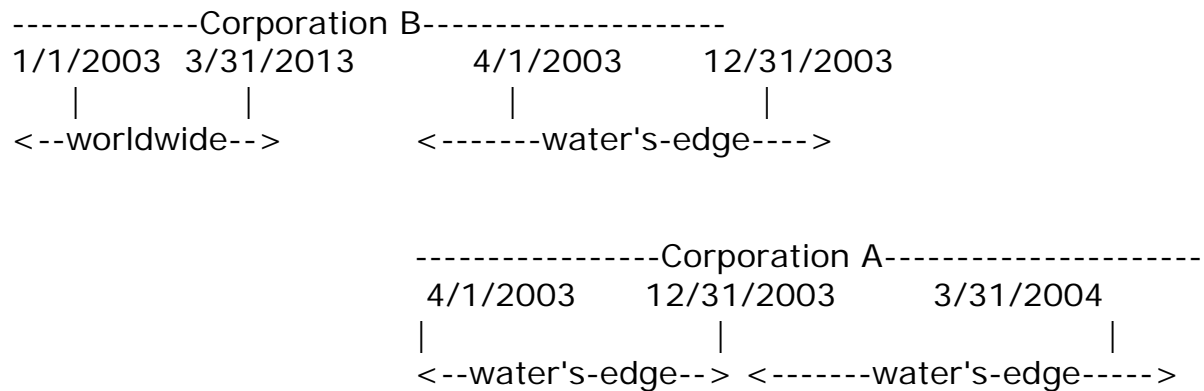
For taxpayers with different fiscal years, each member of the water's-edge group must make the election on its timely filed original return for the taxable year for which the election is being made. The election becomes effective as of the beginning of the taxable year of the last member of the water's-edge group to file its return and the election has the latest taxable

year end. The 84-month election period for each member of the water's-edge group will start from the date that the election becomes effective, i.e., the beginning of the taxable year of the last member of the water's-edge group to elect.

Each taxpayer in the group must compute its tax on a worldwide basis for that portion of the year between the beginning of its taxable year and the beginning of the taxable year of the last member of the group to make the election, and on a water's-edge basis for the remainder of the taxable year. (CCR §25113(g).)

Example

Corporation A's fiscal year ended March 31, 2004. Corporation B's year ended December 31, 2003. Corporation A will be the last member of the group to elect, effective for its taxable year ended March 31, 2004. Thus, the water's-edge group's election begins April 1, 2003, the beginning of A's taxable year. In Corporation B's tax return for 2003, the period January 1 through March 31, 2003 must be given worldwide combination treatment because it includes a period of time preceding the beginning of the taxable year of the last member of the group to elect.



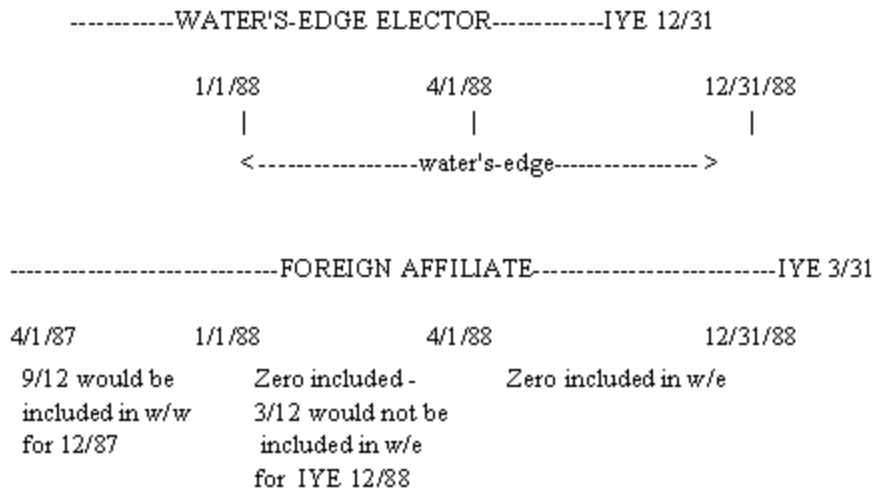
4. Fiscalization

In general, fiscalization is the process of placing the income and formula factors of unitary corporations with differing accounting periods onto a common taxable year-end in order to compute a combined report. (CCR §25106.5-4.)

If a non-taxpayer member of the water's-edge group has a different year-end from that of the taxpayer members, it will have to fiscalize its income to the accounting period of the principal member. However, the general rule

for determining the election start dates for taxpayers with different year-ends will not apply. Non-taxpayer members of the water's-edge group are not required to make the water's-edge election and, therefore, their inclusion in the water's-edge combined report will not affect the start date of the election. This applies whether the non-taxpayer member is a fully included domestic corporation or a partially included foreign corporation.

If a foreign corporation with a different fiscal year-end is unitary but fully excluded from the water's-edge group, it will not normally have to perform any fiscalization during the election term. However, it will have to fiscalize its income to the accounting period of the principle member in order to determine how much income to include in the worldwide combined report prior to the first year of the election and after the last year of the election.



5. Taxpayers with 52-53 Week Accounting Periods

Determining the effective date of a statute for a taxpayer that regularly keeps its books on a 52-53 week accounting period can be confusing since the last day of the taxable year can change from year to year. For purposes of determining the effective date or the applicability of the water's-edge election provisions to a 52-53 week taxpayer, the taxpayer's taxable year is deemed to begin on the first day of the month beginning nearest to the first day of the 52-53 taxable year. (IRC §441(f)(2)(i).) The following example illustrates the effect of this rule:

Example

Corporation A regularly maintains its books and records using a 52-53 week taxable year ending on a Sunday. Corporation A made a water's-edge election for its taxable year beginning December 27, 2002 and ending December 24, 2003. Although Corporation A's taxable year begins prior to the January 1, 2003, the election is treated as if it began on or after January 1, 2003 for purposes of determining the statute's effective date.

I. Changes in Affiliations

In general, the water's-edge filing status of a combined reporting group that has changes in affiliation depends upon the status of the taxpayer (and affiliates, if any) with the greater value of total business assets. (CCR §25113(f)(2).)

The phrase "business assets" means the net book value of assets, including intangible assets, which are:

- Used in the conduct of the business of the unitary affiliated group; or
- Would produce business income to the unitary affiliated group, if an election were not in place, if the assets were sold.

Business assets do not include the stock of a member of the unitary affiliated group. (R&TC §25113(c)(6)(A) and CCR §25113(b)(10).)

The phrase "unitary affiliated group" refers to all of those corporations that would constitute a unitary group if a water's-edge election were not made. (R&TC §25113(c)(6)(B).)

1. Summary of rules relating to changes in affiliation

The following is a summary of additional rules that apply with respect to changes in affiliation of taxpayers that are subject to a water's-edge election:

- If one or more electing taxpayer members of a combined reporting group for any reason leave the group, the water's-edge election remains in effect as to the departing taxpayer members and any remaining taxpayer members. (R&TC §25113(c)(1).)
- If electing taxpayers with different election start dates become members of a new group, the election start date of the new group is

the start date of the taxpayer (and affiliates, if any) whose value of the total business assets are the largest. (R&TC §25113(c)(3).)

- If an electing taxpayer and a non-electing taxpayer become members of a new unitary group, the nonelecting taxpayer is deemed to have elected if the value of the total business assets of the electing taxpayer (and affiliates, if any) is greater than those of the non-electing taxpayer (and affiliates, if any). Otherwise, the election is automatically terminated at the time the electing members become part of the combined report. (R&TC §25113(c)(2).)
- If two non-electing taxpayers with different termination dates become members of a new group, the termination date, together with any associated restrictions on re-election, of the taxpayer (and affiliates, if any) whose total business assets are the largest is the termination date of the new group. (R&TC §25113(c)(4).)

Example

A nonelecting group acquired an electing taxpayer and its unitary subsidiaries. The nonelecting group has larger business assets than those of the electing group.

In the year the entire group is properly combined, the group will file on a worldwide basis because the acquiring group has larger business assets than the electing group. (R&TC §25113(c)(2).)

Example

A water's-edge group acquired a nonelecting taxpayer and its unitary subsidiaries. The water's-edge group has larger business assets than those of the nonelecting group. In the year the entire group is properly combined, the group will file on a water's-edge basis because the acquiring group has larger business assets than the nonelecting group. The commencement date of the deemed election is the commencement date of the acquiring group. (R&TC §25113(c)(2).)

m. Subsequently Taxable

1. Member of the water's-edge combined reporting group

If a member of a water's-edge combined reporting group becomes subject to tax in California subsequent to the election by the group, that member is

deemed to have elected and is bound by the group's water's-edge election. (R&TC §25113(b)(4).)

2. Unitary foreign affiliate of the water's-edge combined reporting group

FTB Notice 2016-02 was issued to address the treatment 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 of a water's-edge election because the affiliate was not subject to tax in California; but after the addition of R&TC §23101(b), the affiliate would have been required to make a water's-edge election for the election to remain effective.

The Notice generally provides that a unitary foreign affiliate is deemed to have participated in or subsequently elected into a combined group's water's-edge election if certain qualifications are satisfied. Subject to all four conditions outlined in the Notice, 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 R&TC §25110(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 §23101(b), the deemed election provisions of R&TC §25113(b)(4) will 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 §23101(b), the affiliate would never have been includable in the water's-edge combined report under R&TC §25110(a)(2)(A)(i) despite its status as a taxpayer under R&TC §23101(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 §23101(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.

The treatment of elections outlined above is limited to situations in which all 4 conditions set forth in the Notice apply (see Notice 2016-02). If all the conditions apply, the FTB will not seek to terminate the water's-edge election of the water's-edge combined group that is unitary with the foreign affiliate that is now a taxpayer.

The deemed election provisions of the Notice will apply only to taxable years beginning within 84 months of September 9, 2016, the date of the Notice.

On October 16, 2017, FTB Notice 2017-04 was issued to extend the treatment set forth in FTB Notice 2016-02. The Notice adheres to and incorporates by reference FTB Notice 2016-02 in all respects, except the specific date constraints listed as conditions for FTB Notice 2016-02 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 modifies the date constrictions found under FTB Notice 2016-02 to include unitary foreign affiliates that become California taxpayers for taxable years beginning on or before December 31, 2017 solely due to the change in law per R&TC §23101(b).

On June 26, 2019, FTB Notice 2019-02 was issued 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 R&TC §23101(b), in a taxable year beginning on or before December 31, 2020.

n. Franchise Tax Board's Audit

If, pursuant to a Franchise Tax Board audit, it is established that an electing taxpayer and a non-electing taxpayer are unitary, the method of filing following the first date that they are properly combined is:

- **Water's-edge** – If the value of the total business assets of the electing taxpayer is larger than the value of the total business assets of the non-electing taxpayer. The water's-edge election will remain in effect, and the non-electing taxpayer is deemed to have elected water's-edge. The commencement date of the deemed water's-edge election is the same as the commencement date of the electing taxpayer. (R&TC §25113(c)(5)(A).)

If the Franchise Tax Board's audit determination is withdrawn or overturned, there is no deemed water's-edge election for the non-electing taxpayer. (R&TC §25113(c)(5)(D).)

- **Worldwide** – If the value of the total business assets of the non-electing taxpayer is larger than the value of the total business assets of the electing taxpayer, then the water's-edge election of the electing taxpayer is terminated as of the date that unity is established. (R&TC §25113(c)(5)(B).)

In forced combinations, the definition of business assets is modified to determine which taxpayer has the greater total business assets. In performing the business assets test, the definition under R&TC §25113(c)(6)(A) is modified to exclude the business assets of other members of the unitary affiliate group that are not taxpayers. See the examples under CCR §25113(c)(2)(A)4.

o. Asset Acquisitions

In general, if a non-water's-edge taxpayer purchases the assets of a water's-edge taxpayer, the water's-edge election does not carryover to the non-water's-edge taxpayer.

If a non-water's-edge taxpayer purchases stock of a water's-edge taxpayer and makes an election pursuant to IRC §338, then the stock purchase is treated as a purchase of the target's assets for all purposes of the code. Consequently, the water's-edge election will not carry over after an IRC §338 election.

p. Consent to Provide Information

1. Purpose of Consent

The purpose of the consent in the election is to prevent issues of service and jurisdiction from being brought up during an audit or administrative review by the Franchise Tax Board, Office of Tax Appeals or judicial proceedings.

The consent does not waive any other defenses or expand or restrict any rights the taxpayer may have. (CCR §25110(c)(2)(A)(3).)

2. Consent Period

The consent is made with the filing of the return containing the water's-edge election. (CCR §25110(c)(2)(A)(1).)

The consent applies to all open years for which the water's-edge election is in effect and remains in effect for each year open for adjustment. The consent does not apply to non-water's-edge taxable years. (CCR §25110(c)(2)(A)(2).)

3. Consent Limitation

The consent is limited to providing the following:

- A. Information necessary to review or adjust income or deductions under the following Internal Revenue Code sections and their regulations:
 - IRC §482, Allocation of Income and Deductions among Taxpayers.
 - IRC §861, Income from sources within the United States.
 - IRC §951, Subpart F rules for Controlled Foreign Corporations (CFCs).
 - Provisions similar to any of the above.
- B. Information necessary to conduct an investigation with respect to any unitary business involving the taxpayer. (CCR §25110(c)(2)(A)(4).)

q. Treatment of Foreign Dividends as Business Income

The water's-edge law and regulations pertaining to dividends as business income prevent the taxpayer from arguing that a State may not tax dividends earned outside its borders unless it can be shown that a unitary business relationship existed with an entity within the State (*ASARCO v. Idaho State Tax Commissioner* (1982) 458 U.S. 307, 102 S Ct 3103, 73 L Ed 2d 787). For water's-edge purposes, the consent requires the taxpayer to agree that dividends are presumed to be business income.

The taxpayer agrees to business income treatment of dividends received from either:

- An over 50 percent owned entity (either directly or indirectly) engaged in the same general line of business as the members of the water's-edge group.
- A bank or corporation (not required to be owned more than 50 percent by a member of the water's-edge group) which:
 - Is a significant source of supply to or a significant purchaser of the output of the members of the water's-edge group, or
 - Sells a significant portion of its output or obtains a significant part of its raw materials or input from members of the water's-edge group.

The term "significant" means an amount equal to or greater than 15 percent applied to the purchases or sales of individual banks or corporations and not to the water's-edge group. (R&TC §25110(b)(2)(B)(ii); CCR §25110(c)(3)(C).)

The term "output" refers to the tangible property produced or sold or service provided. Amounts are to be considered cumulatively and not by category. (CCR §25110(c)(3)(C).)

The terms "source of supply" and "input" refers to the purchase of raw materials or semi-finished products for manufacturing or tangible property for resale. Amounts are to be considered cumulatively and not by category. (CCR §25110(c)(3)(C).)

All other dividends will be classified as business or nonbusiness income in accordance with the general California rules as set forth in R&TC §25120.

r. Summary

This section covers the items dealing with the election, the filing requirements, the effect of the water's-edge election when there are changes in affiliations, and the taxpayer's obligations to provide certain information. The next section covers the requirements and methods for terminating and re-electing water's-edge with and without the Franchise Tax Board's consent.

3.2 Water's-Edge – Terminations and Re-Elections

- a. Introduction
- b. Termination of Water's-Edge Election
- c. Re-Electing Water's-Edge after Termination
- d. Summary

a. Introduction

This section discusses the requirements and what the taxpayer must do to terminate the water's-edge election. It also discusses the re-election requirements after the taxpayer terminates the water's-edge election with and without the Franchise Tax Board's consent.

b. Termination of Water's-Edge Election

For taxable years beginning on or after January 1, 2003, R&TC §25113 describes how and when the water's-edge election is to be made. It also provides the manner in which the water's-edge election may be terminated with or without the consent of the Franchise Tax Board.

1. Automatic Terminations

When two or more taxpayers become unitary, the status of the taxpayer with the larger total business assets will prevail. This result is likely to coincide with a taxpayer's expectations and prevents a larger combined reporting group from becoming unintentionally bound by a water's-edge election when it acquires a smaller water's-edge taxpayer:

- If an electing taxpayer and a non-electing taxpayer become members of a new unitary affiliate group and the value of the total business assets of the non-electing taxpayer is greater than those of the electing taxpayer, the election is automatically terminated. Written notification of termination must be made by every taxpayer that is a member of the water's-edge group (R&TC §25113(c)(2); CCR §25113(d)(3)).
- If an electing taxpayer and a non-electing taxpayer become members of a new unitary affiliate group during the taxable year, the electing taxpayer (and affiliates, if any) must compute its tax liability on a water's-edge basis until the termination. The electing taxpayer (and affiliates, if any) must compute its tax liability for the remaining portion of the taxable year after the termination as part of the non-electing taxpayer's unitary affiliate group. The non-electing taxpayer

(and affiliates, if any) must compute its tax liability on a worldwide basis for the entire year. (CCR §25113(d)(3).)

2. Termination without the Franchise Tax Board's Consent

If the water's-edge election has been in effect for at least 84 months, the taxpayer may terminate the election as permitted under R&TC §25113(c)(9). Every taxpayer in the water's-edge group must elect to terminate. The termination is made in the same manner as making a water's-edge election for the first time. To terminate the water's-edge election without the Franchise Tax Board's consent the taxpayer must:

- File a timely original return, Form 100
- Compute its California tax liability on a worldwide basis
- Attach a statement to the Form 100 explaining that the corporation is terminating its water's-edge election
- Provide the name of any taxpayer that was bound by the water's-edge election

The effective termination date would be the last day of the taxable year immediately preceding this worldwide filing. If the taxpayer terminates its water's-edge election, it is required to file on a worldwide basis for at least 84 months before making another water's-edge election, unless we waive the application of this prohibition period for good cause (CCR §25113(e)(1)).

3. Termination with the Franchise Tax Board's Consent

The taxpayer must obtain the Franchise Tax Board's consent if the water's-edge election has been in effect for less than 84 months. The taxpayer must meet one of two requirements provided under R&TC §25113(c)(10). The requirements are:

- The taxpayer is requesting to terminate the water's-edge election for good cause. Good cause for these purposes has the same meaning as described in Treas. Reg. §1.1502-75(c). (R&TC §25113(c)(10)(A).) In general, good cause refers to a substantial adverse change in water's-edge tax laws affecting the tax liability.
- The taxpayer's purpose for requesting termination is to permit the state to contract with an expatriate corporation, or its subsidiary, pursuant to Public Contract Code §10286(b)(2). (R&TC §25113(c)(10)(B).)

The Franchise Tax Board's consent is not required if the election is being terminated as a result of an affiliation change as provided in R&TC §25113.

A. Consent to Terminate

In general, we will grant the taxpayer's request for consent to terminate the water's-edge election if the taxpayer provides source documentation demonstrating that:

- The taxpayer meets the good cause requirement as described in Treas. Reg. §1.1502-75(c).
- The taxpayer is requesting to terminate the water's-edge election, so it can meet the requirements of Public Contract Code §10286(b)(2).

The request for consent to terminate the water's-edge election must be in writing and must clearly state the reason for the request. If we grant the request, taxpayer will be required to file on a worldwide basis for at least 84 months before making another water's-edge election, unless we waive the application of this prohibition period for good cause.

B. What to File

The taxpayer must timely file form FTB 1117, Request to Terminate Water's-Edge Election. The taxpayer must file form FTB 1117 separately from the tax return. The request must be filed no later than 120 days prior to the due date, including extensions, of the tax return for which the termination would be effective. A form FTB 1117 filed with the return is not valid and will not terminate a taxpayer's water's-edge election. (CCR §25113(d)(2).)

Taxpayers mail form FTB 1117 to:

FRANCHISE TAX BOARD
PO BOX 1779
RANCHO CORDOVA CA 95741-1779

C. Time Period for Franchise Tax Board to Take Action

Generally, the FTB will make a determination and notify the corporation of its termination request within 45 days following receipt of the form FTB 1117. If the FTB takes no action or request no additional information within 90 days, a request for consent to terminate the water's-edge election is deemed disallowed. The taxpayer may withdraw its request at any time before we take action. (CCR §25113(d)(2).)

D. Effective Date

In general, requests for consent to terminate the water's-edge election are effective for:

- The taxable year in which good cause occurred if the request is made for good cause.
- The taxable year in which the expatriate corporation, or its subsidiary, enters into the contract with the state.

The FTB will notify the corporation if its request is approved. If approved, the taxpayer will be required to file on a worldwide basis for at least 84 months before making another water's-edge election. (CCR §25113(d)(2).)

The Franchise Tax Board's consent will not be retroactive.

c. Re-electing Water's-Edge after Termination

If a taxpayer terminates its water's-edge election with or without the Franchise Tax Board's consent on a taxable year beginning on or after January 1, 2003, the taxpayer is required to file on a worldwide basis for at least 84 months before making another water's-edge election. The FTB may waive the application of this prohibition period for good cause. (R&TC §25113(c)(11) and CCR §25113(e).) The rules for re-electing are as follows:

1. Re-Electing Water's-Edge without the Franchise Tax Board's Consent

After having electing to return to a worldwide basis, the taxpayer may re-elect to file on a water's-edge basis without the Franchise Tax Board's consent:

- After having filed on a worldwide basis for at least 84 months, or
- If the termination occurred as a result of certain changes in affiliation. See R&TC §25113, subdivisions (c)(2), (4), and (5).

The taxpayer must still meet the requirements for making a valid water's-edge election. See WEM 3.1, section d, for the requirements for making a water's-edge election.

2. Re-electing Water's-Edge with the Franchise Tax Board's Consent

The taxpayer must obtain Franchise Tax Board's consent to re-elect water's-edge for any taxable year that begins prior to the 84 months period

following the last day of the terminated election. To obtain the Franchise Tax Board's consent to re-elect under good cause, the taxpayer must file form FTB 1115, Request for Consent for a Water's-Edge Re-Election. The Franchise Tax Board's approval of the request for consent to re-elect water's-edge does not constitute making a water's-edge election. After receiving the Franchise Tax Board's consent to re-elect, the corporation must comply with the requirement of making the water's-edge election. (See WEM 3.1.)

A. Requesting FTB Consent to Re-Elect Prior to the 84 Months Prohibition Period

In general, the FTB will grant the taxpayer's request for consent to re-elect water's-edge if the taxpayer provides source documentation demonstrating that it meets the good cause requirement as described in Treas. Reg. §1.1502-75(c). In general, good cause refers to a substantial adverse change in water's-edge tax laws affecting the tax liability.

B. What to File

The taxpayer must file FTB 1115, Request for Consent for a Water's-Edge Re-Election. The taxpayer must file FTB 1115 separately from the tax return. The request must be in writing and must be filed no later than 90 days prior to the due date, including extensions, of the tax return for which the re-election would be effective. A form FTB 1115 filed with the tax return would not be considered timely filed and would be invalid.

Taxpayers mail form FTB 1115 to:

FRANCHISE TAX BOARD
PO BOX 1779
RANCHO CORDOVA CA 95741-1779

C. Time Period for Franchise Tax Board to Take Action

Generally, the FTB will make a determination and notify the corporation on its termination request within 60 days following receipt of the form FTB 1115. If the FTB takes no action or requests no additional information within 60 days of the filing FTB 1115, the request is deemed disallowed. The taxpayer may withdraw its request at any time before the Franchise Tax Board takes action. (CCR §25113(e).)

D. Effective Date

In general, requests for consent to re-elect water's-edge is effective for the taxable year in which good cause occurred, provided that the taxpayer timely files form FTB 1115. The Franchise Tax Board's consent will not be retroactive.

The FTB will notify the corporation if its request is approved. If approved, the taxpayer must comply with the requirements of making a water's-edge election as provided in R&TC §25113. See WEM 3.1 for making a water's-edge election.

Example

A calendar year corporation terminated its water's-edge election effective December 31, 2004. During 2006, there were events that satisfied the good cause requirement for re-electing water's-edge. Corporation A files its request to re-elect, FTB 1115, on June 15, 2008. The taxpayer's request cannot be granted because:

- Good cause occurred during the taxable year ended December 31, 2006, so the request needed to be made 90 days prior to the due date, including extensions, of the 2006 return. The Franchise Tax Board's consent cannot be retroactive. A water's-edge election must be made on a timely filed original return. Form FTB 1115 was not timely filed.
- The filing of the form FTB 1115 would be timely for the taxable year ended December 31, 2007. However, the request cannot be granted because good cause occurred in 2006, not in 2007.

d. Summary

This section covers items dealing with methods of terminating the election and the conditions under which the taxpayer may re-elect water's-edge as provided under R&TC §25113. The next section reviews the penalties that can be assessed on a water's-edge taxpayer if the taxpayer fails to meet certain requirements.

3.3 Penalties

- a. Introduction
- b. Penalties for Failure to Supply Information or Documents
- c. Formal Document Request
- d. Additional Provisions
- e. Summary

a. Introduction

R&TC §25112 requires taxpayers electing water's-edge to retain and make available upon request information described in subdivision (b) of R&TC §25110. See subsection d below. If taxpayers do not provide information as requested, a penalty may be assessed under R&TC §25112. The following procedures should be followed prior to assessing a penalty. The penalty can be assessed 60 days after a written request for information and the taxpayer fails to provide the information requested. The penalty amount is \$1,000 for each taxable year. Additional penalties of \$1,000 per a 30-day period, up to \$24,000, can be assessed per taxpayer for each taxable year if the failure to furnish continues. The total amount of penalties that can be assessed per taxpayer is \$25,000. If this situation arises the FTB auditor should discuss the potential penalty with her/his supervisor.

b. Penalties for Failure to Supply Information or Documents

1. Basis for Assessing Penalty

Before the penalty can be assessed, the taxpayer must be informed in a written request for information that it is subject to the penalty. It must be explained that the penalty is being assessed under R&TC §25112 for either failure to provide information requested or because the taxpayer's prior responses have been unsatisfactory. The penalty cannot be assessed unless the taxpayer has received advance notification. (CCR §25112(a)(3).)

A single request for information may apply to several taxable years (including short periods). It is important to list each taxpayer on the written notice because these penalties are assessed on a "per taxpayer" basis (e.g., list each taxpayer included in a combined report). (CCR §25112(a)(2)(B).)

The penalty is assessed for the failure to furnish information, not for each failure to furnish information, nor for each item of information, or each document not furnished. The failure must also be of a substantial or material nature as shown by:

- The potential significance of the item(s), or
- The quantity of the item(s) not supplied.

(CCR §25112(a)(2)(C).)

2. 60 Days Written Notice

The 60-day written request should not be the first request (e.g., Information Document Requests (IDRs) and letters should already have been issued requesting the information either specifically or generally). The notice will include a list of prior requests and specify the basis (if any) on which prior responses were considered unsatisfactory:

- The request for information must include item(s) described in R&TC §25112(b).
- The written request advises each taxpayer that it is subject to the \$1,000 penalty for failure to furnish information.
- The 60-day written notice will be issued by an FTB auditor or attorney.
- The notice will include a list of prior requests and specify the basis (if any) on which prior responses were considered unsatisfactory.
- The taxpayer has 60 days from the date of mailing to respond.
- The 60-day period will be suspended during the time the question of reasonable cause is under review. (See Item 5-"Reasonable Cause" below.)

3. \$1,000 Penalty

The \$1,000 per taxpayer failure to furnish penalty can be issued any time after the expiration of the 60-day period. The audit need not be completed.

4. 90-Days Written Notice

If the failure to furnish information continues after the 60-day period expires, a 90-day written notice will be sent to each taxpayer informing it of the failure and of the fact that an additional penalty of \$1,000 per 30-day period (or fraction thereof) may be assessed. The additional penalty may not exceed \$24,000. A total penalty of \$25,000 may be assessed for each taxpayer for each taxable year. (CCR §25112(a)(4).)

- The 90-day notice will be issued by a Bureau Director or a supervising Counsel.
- The notice will include a list of prior requests and specify the basis on which prior responses were considered unsatisfactory.

- The 90-day notice will advise each taxpayer that the initial penalty of \$1,000 will be assessed.
- The 90-day notice will advise each taxpayer that an additional penalty of \$1,000 per 30-day period (or fraction thereof) may be assessed for further failure to furnish information. The additional penalty is not to exceed \$24,000 for each taxable year.
- The taxpayer has 90 days from the date the notice is mailed to respond.
- The 90-day period will be suspended during the time the question of reasonable cause is under review.

5. Reasonable Cause For 60-Day and 90-Day Notices

The penalties under R&TC §25112(a) will not apply if the taxpayer establishes that the failure to provide information is due to reasonable cause. The 60-day or 90-day periods do not begin until the issue of reasonable cause no longer exists. The periods will be suspended during the time the question of reasonable cause is under review. (CCR §25112(a)(5)(B).)

A. Showing Reasonable Cause

To show that reasonable cause existed, the taxpayer must provide a written statement showing all facts substantiating the reasonable cause and include a declaration that it is made under the penalties of perjury. The taxpayer must file this statement with the Bureau Director or Supervising Counsel who signed the 90-day written notice.

The Bureau Director or Supervising Counsel will determine whether the failure to furnish information was due to reasonable cause. Notification of the determination will be given to the taxpayer. (CCR §25112(a)(5)(C).)

B. Destruction or Retention of Information

Destruction of or failure to retain documents or information is reasonable cause if it occurred in the normal course of business. However, failure to maintain documents or information required under the water's-edge provisions of the R&TC is not reasonable cause. (CCR §25112(a)(5)(D).)

Reasonable cause for a period not to exceed 90 days exists if a document or information is located in a foreign country.

6. Assessing Penalties

The initial penalty is assessed in the same manner as assessing the additional tax. The penalty can be assessed immediately without having to wait until the audit is completed.

The additional penalty is also assessed in the same way as assessing the tax except that the notice need not be issued until the full penalty has accrued. The taxpayer pursuing its protest rights on the initial \$1,000 penalty assessment does not prevent the accrual and assessment of the additional \$1,000 per month penalties. (CCR §25112(a)(7).)

c. Formal Document Request

A formal document request is defined under R&TC §25112(g) as any request for the production of documentation which is mailed by registered or certified mail to the taxpayer at its last known address and is made after the normal request procedures have failed to produce the requested documentation. It can be issued during any stage although it should be made after normal written request procedures have been unsuccessful. The penalties provided for by R&TC §25112 subsections (a) and (b) do not have to be imposed for the requirement of a normal request procedure to be met.

1. Requirements for Request

A. Mailing

The formal document request must be mailed to the last known address and sent by registered or certified mail to the taxpayer (or taxpayers).

B. Request Procedure

The request must include:

- Time and place for the production of the documentation.
- A statement of the reason the documentation previously provided (if any) was not sufficient.
- A description of the documentation being requested.
- Description of the consequences (e.g., penalties, exclusion of records, and/or disregard) to the taxpayer for failure to produce the requested documentation.
- The statement must be signed by the Assistant Executive Officer, Audit Division Chief or the Chief Counsel of the Franchise Tax Board.

- The request may also include a requirement that an English translation of any foreign documents be supplied if it exists.

(See CCR §25112(b)(2)(B).)

2. Reasonable Cause for Failure to Produce

A penalty will not apply if the taxpayer establishes that the failure to provide information is due to reasonable cause. If delays for failure to furnish information are due to reasonable cause, the 90-day period will begin on the last day that reasonable cause existed.

A Superior Court will determine if reasonable cause existed. The court will consider:

A. Whether the scope of the request is reasonable.

Examples:

- The reasonableness of a demand for the production of the originals of foreign documents rather than copies may be resolved in court. If the foreign country makes it impossible to remove the original documents requested not because of secrecy laws but, for example, because of its tax laws or laws as to the rights of creditors, true copies may be sufficient.
- A reasonable delay may be due to translation of documents into English per Franchise Tax Board's request.
- Minority Status - facts and circumstances will dictate whether a minority interest in an entity that has custody of a document is reasonable cause.

B. Whether the requested documents or copies are available within the U.S.

Example:

- The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause unless the court finds it to be.

C. Whether the place of production within the U.S. is reasonable.

See R&TC §25112(f) and CCR §25112(b)(4).

3. Motion to Quash

A quash refers to a motion to request a court to order the formal document request (e.g., subpoena) unenforceable. R&TC §25112(i) gives jurisdictions to the superior courts of the State of California for the Counties of Los Angeles, Sacramento, San Diego, and San Francisco to hear proceeding seeking to quash the formal document request.

A judicial proceeding to quash the formal document request may be commenced within 90 days of the mailing of the request.

4. Grounds to Quash

A. Grounds:

- A contention that all parts of the requested documentation are irrelevant to the issue.
- The place of production is unreasonable.
- Reasonable cause exists for failure to produce.
- Reasonable cause exists for delay in production.
- Reasonableness of requesting original documents rather than copies when, for example, foreign laws prevent their removal.

See CCR §25112(b)(5)(A).

B. Burden of Proof

FTB has the burden of proving:

- The relevance and materiality of the requested records
- That the audit is being conducted for a legitimate purpose
- That the information sought is not already within its possession
- That the administrative steps required have been followed

See CCR §25112(b)(5)(D).

C. Time to Comply

The taxpayer has 90 days from the day of mailing the formal document request to comply.

The Franchise Tax Board or the Superior Court may grant the taxpayer a 90-day extension period to comply.

Any action to quash results in the suspension of the 90-day period. The running of any period of limitations for issuing notices of proposed deficiency assessment under R&TC §§19057 to 19064 will be suspended for the period during which the proceedings to quash and appeals are pending.

See CCR §25112(b)(5)(E).

D. Motion to Prohibit Introduction of Document

After the expiration of the 90-day period, the FTB may bring a motion to prohibit introduction of the requested documents in any subsequent judicial or administrative proceeding.

The fact that a document is not required to be maintained, has not been maintained, or has been destroyed will not prevent a court from issuing an order providing for the exclusion of a later discovered copy of the document.

This "exclusion" rule is based on the exclusion of foreign records provision found in IRC §982. It was applied for the first time in *Flying Tigers Oil Co., Inc. v. Commissioner*, 92 TC 1262. After sending numerous IDRs with no response by the taxpayer, the IRS followed with a summons containing a request for the original IDR information and a warning that foreign-based documents could be excluded from subsequent litigation. The IRS issued a deficiency notice based on information available. The Tax Court refused to allow the taxpayer to introduce any foreign-based documents. It also excluded the taxpayer's domestic documentation which it found was either based on or prepared in reliance on such foreign documents.

See R&TC §25112(d) and CCR §25112(b)(5)(B).

d. Additional Provisions

For taxable years beginning on or after January 1, 1994, a taxpayer will be subject to the penalties under R&TC §25112 if it willfully fails to retain the materials described below. The information must be maintained for the period of time during which the taxpayer's tax liability may be adjusted, including for the period of time during which the appeal is pending before Office of Tax Appeals or a lawsuit is pending in the courts.

1. Information That Must Be Retained

The taxpayer will be subject to the penalties if it willfully fails to do the following:

- A. Retain and make available documents and information involving the attribution of income between the U.S. and foreign jurisdictions. (As normally examined under IRC §§ 482, 861, 863, 902, 904, and Subpart F.)
- B. Identify principal officers or employees who have substantial knowledge of and access to information on the allocation of cost and profits and prices of goods and services.
- C. Retain and make available documents and correspondence submitted to or obtained from the IRS, tax agencies of foreign countries, and competent authority. For the audit procedures, see WEM 18.

The documents (with English translation if available) include but are not limited to:

- Ruling requests on reorganizations involving foreign branch incorporation
 - Determination of foreign tax liability including reports issued by foreign tax administrators.
- D. Foreign Transactions – Retain and make available any forms filed with the IRS to comply with IRC §§ 6038, 6038A, 6038B, 6038C, and 6041. These are IRS Forms 851, 926, 5471 (Worksheets A and B and Schedule M), 5472.
 - E. Prepare and make available information similar to that which is required of foreign corporations under IRC §§ 6038, 6038A, 6038B, 6038C and 6041 for each bank or corporation incorporated in the U.S. which has 50 percent or more of its stock owned or controlled, directly or indirectly, by a bank or corporation in the water's-edge group.

The consolidating workpapers used to prepare the consolidated financial statements for reporting to shareholders will normally meet this requirement.

- F. Prepare and make available all state tax returns filed by each bank or corporation in the water's-edge group.
- G. Comply with reasonable request for information necessary to determine or verify net income and apportionment factors, or geographic source of income under IRC.

e. Summary

Key elements of the failure to furnish penalty provisions:

- The initial penalty is \$1,000 per taxpayer per year.
- The additional penalty is \$1,000 per 30-day period up to \$24,000.
- The taxpayer must be informed in a written notice that it is subject to the penalty. You or an attorney will issue the 60-day written notice. A Bureau Director or Supervising Counsel will issue the 90-day notice.
- The taxpayer must show reasonable cause to avoid the penalties.