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FTB NOTICE 2004-2

May 3, 2004

SUBJECT: Implementation of New Water's-Edge Election Statute

For taxable years beginning on or after January 1, 2003, the manner of making a water's-edge election has been substantially changed. Revenue and Taxation Code section 25113 (added by Stats. 2003, ch. 633, § 10) replaces the contract with a statutory election that continues in effect for a minimum of 84 months (seven years). For taxpayers that have made a water's-edge election prior to January 1, 2003, see **Examples of the Interaction Between Revenue and Taxation Code Sections 25111 and 25113** below.¹

As a result of the new provisions, the following changes are applicable.

Making a Water's-Edge Election

To make a water's-edge election under Revenue and Taxation Code section 25113, a corporation must do each of the following:

- Compute its income on a water's-edge basis;
- Use Form 100W, California Corporation Franchise or Income Tax Return-Water's-Edge Filers; and,
- Attach the Form 100-WE, Water's-Edge Election, to the timely filed original return (Form 100W) for the year of the election.²

A water's-edge election must be for an initial term of 84 months and remains in effect thereafter, year by year, until terminated by the taxpayer. Corporations that have a valid election for taxable years beginning before January 1, 2003, will continue to file on a water's-edge basis and will be deemed to have elected under the new statute (Rev. &

¹ See also the amendments to Revenue and Taxation Code section 25111 added by Stats. 2003, ch. 633, § 9.

² 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. For examples of what constitutes an original return, see the examples under California Code of Regulations, title 18, section 25111, subdivision (e)(2).

Tax. Code, § 25113) for taxable years beginning on or after January 1, 2003. However, the original commencement (start) date, as elected under Revenue and Taxation Code section 25111, remains in effect.

To illustrate: Corporation A, a calendar year taxpayer, elected to file on a water's-edge basis starting January 1, 2000. For taxable years beginning on or after January 1, 2003, Corporation A must continue to file on a water's-edge basis and is deemed to have elected under the new statute. However, the election start date for purposes of Revenue and Taxation Code section 25113 continues to be January 1, 2000. For the year beginning January 1, 2007, and each year thereafter, the taxpayer may file on a water's-edge basis without triggering a new 84-month election period or may terminate its election by filing on a worldwide basis (see *infra*, Termination of Election Without the FTB's Consent).

Effect of Different Fiscal Years

In the case of 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 shall become effective as of the beginning of the taxable year of the last member of the water's-edge group to file its return and election. 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.

Form FTB 1116, Notice of Nonrenewal of Water's-Edge Contract

As a result of the addition of section 25113 to the Revenue and Taxation Code:

- Form FTB 1116, Notice of Nonrenewal of Water's-Edge Contract, is obsolete.
- As of January 1, 2003, there is no need to file a Notice of Nonrenewal.
- A Notice of Nonrenewal filed prior to January 1, 2003, under Revenue and Taxation Code section 25111, subdivision (d), that would have caused a water's-edge contract to end on a date that falls within a taxable year that begins on or after January 1, 2003, will no longer have any effect under Revenue and Taxation Code section 25111, subdivision (f) and section 25113, subdivision (f). The provisions of Revenue and Taxation Code section 25113 will be controlling for taxable years beginning on or after January 1, 2003.

A taxpayer is not harmed by the fact that a previously filed Notice of Nonrenewal ceases to have any effect for taxable years beginning on or after January 1, 2003, because Revenue and Taxation Code section 25113, subdivision (f), does not provide for the addition of another year to the election period in the absence of a Notice of Nonrenewal. Instead, after the initial 84-month election period, the water's-edge election may be terminated without the Franchise Tax Board's (FTB) consent under Revenue and Taxation Code section 25113, subdivision (c)(9). The 84-month period begins on the start date of the water's-edge election as originally made under Revenue and Taxation Code section 25111.

Termination of Election Without the FTB's Consent

For taxable years beginning on or after January 1, 2003, Revenue and Taxation Code section 25113 describes how and when the water's-edge election is to be made. In addition, this section provides the manner in which the water's-edge election may be terminated with or without the consent of the FTB.

If the water's-edge election has been in effect for at least 84 months, the taxpayer may terminate the election as permitted under Revenue and Taxation Code section 25113, subdivision (c)(9) by timely filing an original tax return on form FTB 100 on a worldwide basis. 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.

Termination of Election with the FTB's Consent

Consent for termination is required if the taxpayer is seeking to terminate the water's-edge election for good cause prior to the expiration of the initial 84-month period. Good cause in this circumstance has the same meaning as specified in Treasury Regulation section 1.1502-75(c). (Rev. & Tax. Code, § 25113, subd. (c)(10).) Consent given by the FTB will not be retroactive.

In general, the request for consent to terminate the water's-edge election will be granted only if the taxpayer demonstrates that it meets the good cause requirements as provided under Treasury Regulation section 1.1502-75(c). If the FTB grants the request, the taxpayer will be notified, and it will be effective for the taxable year in which good cause occurred. Thereafter, the taxpayer will be required to file on a worldwide basis for at least 84 months before making another water's-edge election.

The basis for the request to terminate for good cause must be in writing and must clearly state the reason for the request. The taxpayer may withdraw its request at any time before the FTB takes action. A taxpayer must file form FTB 1117 (Request to Terminate Water's-Edge Election) with the FTB no later than the 90th day prior to the

due date, including extensions, of the return for which the termination would be effective. Form FTB 1117 must be filed separately from any tax return.³

Re-electing Water's-Edge Without the FTB's Consent

After termination, with or without the FTB's consent, the taxpayer may re-elect to file on a water's-edge basis without the FTB's consent for any taxable year that begins at least 84 months following the last day of the election period that was terminated.

Re-electing Water's-Edge with the FTB's Consent

After termination, with or without the FTB's consent, the taxpayer must obtain FTB's consent to re-elect water's-edge for any taxable year that begins prior to the 84 month period following the last day of the terminated election. To obtain the FTB's consent, the taxpayer must demonstrate good cause as provided under Treasury Regulation section 1.1502-75(c). The basis for the request to re-elect for good cause must be in writing and must clearly state the reason for the request. The taxpayer may withdraw its request at any time before the FTB takes action.

A taxpayer seeking to re-elect by demonstrating good cause must make the request on a form FTB 1115 (Request for Consent for a Water's-Edge Re-Election) and it must be filed no later than the 90th day prior to the due date, including extensions, of the return for which the new election would be effective. Form FTB 1115 must be filed separately from any tax return.

Examples of the Interaction Between Revenue and Taxation Code Sections 25111 and 25113

Questions have arisen as to the interaction between the rules for elections under Revenue and Taxation Code sections 25111 and 25113. The following examples illustrate this interaction.

1. A calendar year taxpayer made a water's-edge election beginning January 1, 1994, and filed a Notice of Nonrenewal to end the contract on December 31, 2001. The taxpayer did not file a new contract for the taxable year ended on December 31, 2002, but continued to file on a water's-edge basis on an original return that contained other objective evidence of an intended water's-edge election. May the taxpayer terminate its water's-edge election for the year ended December 31, 2004, without the FTB's consent as provided under Revenue and Taxation Code section 25113, subdivision (c)(9)?

Answer: No. The taxpayer cannot terminate without the FTB's consent pursuant to Revenue and Taxation Code section 25113, subdivision (c)(9), for the year ended

³ Form FTB 1117 (Request to Terminate Water's-Edge Contract renamed Request to Terminate Water's-Edge Election) is no longer available within the Form 100W, Water's-Edge booklet. Forms FTB 1115 and FTB 1117 are available online.

December 31, 2004. It could terminate without the FTB's consent only after the 84-month period that ends December 31, 2008.

The taxpayer's election, entered into for the 1994 taxable year, ended on December 31, 2001, because the filing of the Notice of Nonrenewal prevented automatic annual renewal of the contract. However, for the taxable year ended December 31, 2002, the taxpayer had a valid new water's-edge contract, because there was substantial performance of the requirements for entering into a water's-edge contract. Therefore, the taxpayer had a new water's-edge contract with a start date of January 1, 2002. As a consequence, under Revenue and Taxation Code section 25111, subdivision (f) and section 25113, subdivision (f), the taxpayer's start date of the election is January 1, 2002. Because the taxpayer's election will not have been in existence for 84 months on December 31, 2004, the taxpayer must obtain the FTB's consent to terminate.

2. The taxpayer elected to file on a water's-edge basis beginning April 1, 1995, for fiscal year ended March 31, 1996, and the taxpayer filed a Notice of Nonrenewal to end the contract on March 31, 2003. For the taxable year ended March 31, 2004, the taxpayer filed on a worldwide basis. Can the taxpayer make another water's-edge election without the FTB's consent for a taxable year that begins within the 84-month period after March 31, 2003?

Answer: Yes. The taxpayer's election contract under Revenue and Taxation Code section 25111 ended on March 31, 2003, due to the previously filed Notice of Nonrenewal. Revenue and Taxation Code section 25113 is operative with respect to this taxpayer for its taxable years beginning on or after April 1, 2003. Therefore, the taxpayer could have made a new election under Revenue and Taxation Code section 25113, but it chose to file its return for the taxable year ended March 31, 2004, on a worldwide basis.

However, the filing on a worldwide basis for the year ended March 31, 2004, did not constitute a "termination" of a water's-edge election under Revenue and Taxation Code section 25113, because the taxpayer had not made a water's-edge election for its taxable year beginning on or after January 1, 2003. For taxable years beginning after March 31, 2004, the taxpayer is a worldwide taxpayer and is able to re-elect water's-edge under Revenue and Taxation Code section 25113 without requesting the FTB's consent.

3. The taxpayer elected to file on a water's-edge basis beginning April 1, 1996, for a fiscal year ended March 31, 1997, and the taxpayer filed a Notice of Nonrenewal to end the contract on March 31, 2004. For the taxable year ended March 31, 2005, the taxpayer filed on a worldwide basis. Can the taxpayer make another water's-edge election without the FTB's consent for a taxable year that begins within the 84-month period after March 31, 2004?

Answer: No, the taxpayer cannot make another water's-edge election within the 84-month period after March 31, 2004, without getting the FTB's consent. The taxpayer effectively terminated its water's-edge election, pursuant to Revenue and Taxation Code section 25113, subdivision (c)(9), when it filed on a worldwide basis for the taxable year ended March 31, 2005.⁴ The taxpayer would not be able to make another election without the FTB's consent until 84 months have passed from March 31, 2004.

4. The taxpayer elected to file on a water's-edge basis beginning January 1, 1994, and filed a Notice of Nonrenewal to end the contract on December 31, 2006. Must the taxpayer request the FTB's consent to terminate the election prior to December 31, 2006?

Answer: No, the taxpayer is not required to request the FTB's consent to terminate the election under these facts. As of January 1, 2003, the taxpayer is deemed to have elected under Revenue and Taxation Code section 25113, with a start date of January 1, 1994. Because the election will have been in effect for longer than 84 months, the taxpayer may terminate the election as permitted under Revenue and Taxation Code section 25113, subdivision (c)(9), by timely filing an original tax return on form FTB 100 on a worldwide basis. The end date of the original contract is governed by the provisions of Revenue and Taxation Code section 25113. The previously filed Notice of Nonrenewal has no effect.

Changes in Affiliation

In general, the water's-edge filing status of a combined reporting group that has changes in affiliation will depend upon the status of the taxpayer (and affiliates, if any) with the greater value of total business assets.⁵ 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. (Rev. & Tax. Code, § 25113, subd. (c)(1).)

⁴ The taxpayer's filing of the Notice of Nonrenewal has no effect because it caused the water's-edge contract to end on a date that falls within a taxable year that begins on or after January 1, 2003. (Rev. & Tax. Code, §§ 25111, subd. (f), 25113, subd. (f).)

⁵ In general, "business assets" refers to the assets used in the conduct of the business of the unitary affiliate group. Business assets include intangible assets, but do not include the stock of a member of the unitary affiliate. Business assets are valued at net book value. (Rev. & Tax. Code, § 25113, subd. (c)(6)(A).)

- If electing taxpayers with different election start dates become members of a new group, the election start date of the new group shall be the start date of the taxpayer (and affiliates, if any) whose total business assets are the largest. (Rev. & Tax. Code, § 25113, subd. (c)(3).)
- If an electing taxpayer and a non-electing taxpayer become members of a new unitary group, the nonelecting taxpayer shall be 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 shall automatically be terminated at the time the electing members become part of the combined report. (Rev. & Tax. Code, § 25113, subd. (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 shall be the termination date of the new group. (Rev. & Tax. Code, § 25113, subd. (c)(4).)

Examples

1. An electing taxpayer and its unitary subsidiaries are acquired by a nonelecting group that has larger business assets than those of the electing group. What is the election status of the new combined group?

Answer: 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. (Rev. & Tax. Code, § 25113, subd. (c)(2).)

2. A nonelecting taxpayer and its unitary subsidiaries are acquired by an electing group that has larger business assets than those of the non-electing group. What is the election status of the new combined group?

Answer: 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 non-electing group. The start date of the deemed election is the start date of the acquiring group. (Rev. & Tax. Code, § 25113, subd. (c)(2).)

3. The taxpayer's election has been terminated and it becomes a member of a new unitary group that includes one or more non-electing taxpayers that have no restrictions upon their ability to elect. The total business assets of the taxpayer with the terminated election are larger than those of its new affiliates. What, if any, are the restrictions on the ability of the new combined group to make a water's-edge election?

Answer: All members of the group will be restricted from making a new election for the period of time for which the taxpayer that had a terminated election is restricted. (Rev. & Tax. Code, § 25113, subd. (c)(4)(A).)

4. In the facts set forth in example 3, what would be the effect if the non-electing taxpayers that have no restrictions upon their ability to elect, have larger business assets?

Answer: None of the taxpayer members of the new unitary group will be subject to any restrictions on making a new water's-edge election. (Rev. & Tax. Code, § 25113, subd. (c).)

Forms and Instructions

Water's-edge forms and instructions are available at the FTB's website at: www.ftb.ca.gov. Forms requesting the FTB's consent must be mailed under separate cover to:

FRANCHISE TAX BOARD
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