

SALT WATCH



California Franchise Tax Board Issues Notice On The Treatment of Existing Water's-Edge Elections When a Foreign Affiliate Becomes Subject to Tax in California

Summary

Beginning in 2011, California enacted its factor presence statute under which an out-of-state corporation, including a non-U.S. corporation, with more than \$500,000 of gross receipts (indexed for inflation) sourced to California is subject to the state's corporation income/franchise tax and becomes a California taxpayer. However, since such "new" taxpayer never consented to the water's-edge election, the election could be terminated for that electing group. In FTB Notice 2016-02 (Sept. 9, 2016), the California Franchise Tax Board ("FTB") addresses the treatments the FTB will apply in situations where a unitary foreign affiliate of a water's-edge combined reporting group becomes subject to income/franchise tax after the enactment of the "factor presence nexus" statute beginning January 1, 2011.

Details

Background

A multinational unitary group of affiliated corporations, one or more of whose members are subject to California corporation income/franchise tax, may make a water's-edge election to allocate and apportion income of the unitary group's business. Under Cal. Rev. & Tax. Code § 25111(a), a water's-edge election is effective for an initial term of 84 months (seven years), unless terminated earlier under Cal. Rev. & Tax. Code § 25113. The water's-edge election automatically continues after the seven year anniversary date, unless a worldwide combined reporting election is made.

In general, when a water's-edge election is made, the income (or loss) and apportionment factors of a unitary foreign affiliate of the group are excluded from the California water's-edge combined report under Cal. Rev. & Tax. Code § 25110, as long as the unitary foreign affiliate does not have effectively connected income with a U.S. trade or business, or at least 20% of its apportionment factors assigned to U.S. locations (collectively, "United States Income").



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Pursuant to Cal. Rev. & Tax. Code § 25113, a water's-edge election is effective only if every member of the water's-edge group with nexus in California (a "taxpayer member") makes or consents to the election. If a unitary foreign affiliate did not have a physical presence with California for taxable years prior to January 1, 2011, it could not have made or consented to the water's-edge election. During those years, the unitary foreign affiliate was not a taxpayer.

For taxable years beginning on or after January 1, 2011, Cal. Rev. & Tax. Code § 23101(b) was added. Section 23101(b) established a "factor presence economic presence" standard for an out-of-state corporation, including a unitary foreign affiliate, to be considered "doing business" in California. Among other factor-presence criteria, an out-of-state corporation with more than \$500,000 of gross receipts sourced to California under California's sales factor sourcing rules was now deemed "doing business" in California and subject to income/franchise tax.¹ When applied to a unitary foreign affiliate with no physical presence but more than \$500,000 of California sales after January 1, 2011, the affiliate becomes a California taxpayer. Since the unitary foreign affiliate never made nor consented to the making of the water's-edge election, the election could be terminated for the entire group under Section 25113, an issue that the FTB has raised in audit examinations.

Under Cal. Rev. & Tax. Code § 25113(b)(4), if a member of the water's-edge group subsequently becomes subject to California corporation income/franchise tax and becomes a taxpayer member of the water's-edge group, the deemed election provisions apply and the new taxpayer member is deemed to have made or consented to the water's-edge election. As a result, if an out-of-state unitary affiliate, including a non-U.S. unitary affiliate with United States Income, later becomes a taxpayer member of the water's-edge group because of the "factor presence economic nexus" statute, the water's-edge election does not terminate. Prior to 2011, both types of entities were already "members" of the California water's-edge group.

Nonetheless, the deemed election provisions of Section 25113(b)(4) are silent as to the treatment when a non-member unitary foreign affiliate becomes a California taxpayer.

FTB Notice 2016-02

In FTB Notice 2016-02, issued on September 9, 2016, the FTB acknowledges that neither Cal. Rev. & Tax. Code § 25113 nor the regulations thereunder address the effect on an existing water's-edge election due entirely to a change in law (i.e., enactment of Cal. Rev. & Tax. Code § 23101(b)) that changes the status of a non-electing unitary foreign affiliate from a non-taxpayer and non-member to a California taxpayer. The Notice addresses three situations and provides the following "treatments":

First, as noted above, if a unitary foreign affiliate has United States Income both before and after the taxable year in which California's "factor presence economic nexus" statute makes the affiliate a taxpayer member, the deemed election provisions of Cal. Rev. & Tax. Code § 25113(b)(4) apply and the group's water's-edge election remains intact.

¹ California's "factor presence economic nexus" statute is indexed for inflation. Cal. Rev. & Tax. Code § 23101(b)(2), (c). California's sales factor presence threshold was \$500,000, \$509,500, \$518,162, \$529,562, and \$536,446 for 2011, 2012, 2013, 2014, and 2015, respectively.



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If a unitary foreign affiliate does not have United States Income and becomes a California taxpayer after January 1, 2011, by virtue of the "factor presence economic nexus" statute, the FTB will treat the affiliate as deemed to have made the water's-edge election. As a result, the water's-edge election remains intact.

Finally, if a unitary foreign affiliate did not have United States Income before, but has United States Income after the taxable year in which it becomes a California taxpayer, the FTB will treat the affiliate as deemed to have made the water's-edge election. Likewise, the water's-edge election remains intact.

Under the second and third situations, the commencement date of the unitary foreign affiliate's deemed election is the same as the commencement date of the taxpayer members who actually made the existing California water's-edge election.

The "Conditions"

FTB Notice 2016-02 may provide relief for some California water's-edge groups having to contend with California's "factor presence economic nexus" statute. Unfortunately, any relief that the "treatments" provided by FTB Notice 2016-02 are limited, including for taxable years ending on or before December 31, 2016.

For the preceding treatments to apply, FTB Notice 2016-02 imposes the following conditions, all of which must be satisfied:

1. There must have been a valid water's-edge election made prior to September 9, 2016;
2. At the time the water's-edge election was made, the unitary foreign affiliate could not make the election because the affiliate was not subject to California income/franchise tax;
3. The unitary relationship between the water's-edge group and the foreign affiliate remained continuously in effect between the time the water's-edge election was made and the time the foreign affiliate became a California taxpayer; and
4. The unitary foreign affiliate became a California taxpayer under the "factor presence economic nexus" statute on or before December 31, 2016.

If all four of these conditions are satisfied, the FTB will not seek to terminate the water's-edge election.

The "First Seven-Year" Issue

A water's-edge election is effective for an initial term of seven years and continues each taxable year thereafter unless a worldwide combined reporting election is made. It could be argued that the issues or situations raised in FTB Notice 2016-02 only arise if or when the "factor presence economic nexus" statute results in a unitary foreign affiliate becoming a California taxpayer after the first seven years of the water's-edge election. The FTB could also take a position that the water's-edge filing continues until the end of the first seven-year period and then terminates. The FTB did not address this issue and whether the economic/factor presence in California of the unitary foreign affiliate could terminate the group's water's-edge election in the first seven years of the election.



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There are some water's-edge groups that, due to unforeseen circumstances, would prefer to terminate the water's-edge election prior to the expiration of the seven-year period. In general, the only way a water's-edge group can terminate the election prior to the expiration of the first seven years is to request permission from the FTB. However, if a non-member unitary foreign affiliate (i.e., an affiliate without United States Income) establishes economic/factor nexus by simply selling inventory to its California affiliate in excess of the California sales threshold, then the water's-edge election could be terminated without having to seek permission. At this point, it is not certain if this issue will apply to the first seven years of a water's-edge election since it was not addressed by the FTB Notice.

Insights

- FTB Notice 2016-02 addresses an issue that simply was not anticipated when California enacted and amended its water's-edge election statutes and the FTB's water's-edge regulations were issued in the years prior to January 1, 2011, when "factor presence economic nexus" came to California.
- The "treatments" that will be followed by the FTB will be limited to water's-edge electing groups for taxable years ending on or before December 31, 2016.
- Further, uncertainties with the application of California's market-based sourcing rules under the facts and circumstances may make it difficult for the California water's-edge group to determine with certainty whether a unitary foreign affiliate has California sourced income. If the foreign affiliate has service revenue, enters into a licensing agreement, or sells intangible property, it may be difficult to determine if the income will be sourced to California and will establish economic nexus as a result.
- It is unclear if the issues addressed in FTB Notice 2016-02 apply to the first seven years of the water's-edge election, since the Notice did not make such a distinction. It is possible that a water's-edge group could terminate a water's-edge election in the first seven years of the election without receiving FTB approval if a unitary foreign affiliate that does not have United States Income establishes economic/factor nexus in California and is therefore considered a California taxpayer.

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