

Introduced by Senator Scott

February 23, 2001

An act to amend Section 25111 of, and to add Sections 18405.1, 25113, and 25116 to, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

SB 657, as introduced, Scott. Bank and corporation taxes: water's-edge election.

The Bank and Corporation Tax Law allows corporations to elect whether their income is determined on a "water's-edge" basis or on a worldwide unitary basis. The election to report income on a water's-edge basis is made by contract between the taxpayer and the Franchise Tax Board. The contract requirements allow no relief for errors, and do not allow the perfecting of invalid water's-edge elections. Electors who fail to comply with the contractual requirements for making a water's-edge election forfeit their water's-edge election, thereby causing their income to be determined on a worldwide unitary basis.

This bill would revise water's-edge election procedures by, among other things, providing that elections made under current law may be perfected, and by providing that elections be made by statutory election, as provided, rather than by contract.

This bill would take effect immediately as a tax levy.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

1 SECTION 1. Section 18405.1 is added to the Revenue and
2 Taxation Code, to read:

3 18405.1. (a) Notwithstanding Section 18405, the Franchise
4 Tax Board may, in its discretion, permit elections made under
5 Section 25111 to be perfected during the period of limitations
6 prescribed under Sections 19057 and 19306 for the applicable
7 income year. The statute of limitations of all taxpayers in a
8 water's-edge group whose income year falls, in whole or in part,
9 within the period of the election shall remain open to receive
10 adjustments, under claim or deficiency consistent with that
11 perfection of the election.

12 (b) Subdivision (a) does not apply to the 1988 income year of
13 any taxpayer whose water's-edge election has been perfected
14 pursuant to Section 18405.

15 SEC. 2. Section 25111 of the Revenue and Taxation Code is
16 amended to read:

17 25111. (a) ~~The~~ *For taxable years beginning before January*
18 *1, 2000, the* making of a water's-edge election as provided for in
19 Section 25110 shall be made by contract with the Franchise Tax
20 Board in the original return for a year and shall be effective only
21 if every taxpayer that is a member of the water's-edge group and
22 which is subject to tax under this part makes the election. A single
23 taxpayer that is engaged in more than one business activity subject
24 to allocation and apportionment as provided in Article 2
25 (commencing with Section 25120) of Chapter 17 may make a
26 separate election for each business. The form and manner of
27 making the water's-edge election shall be prescribed by the
28 Franchise Tax Board. Each contract making a water's-edge
29 election shall be for an initial term of 84 months, except as
30 provided in subdivision (b). Each contract shall provide that on the
31 anniversary date of the contract or any other annual date specified
32 by the contract a year shall be added automatically to the initial
33 term unless notice of nonrenewal is given as provided in
34 subdivision (d). An affiliated corporation that is a member of the
35 water's-edge group and subsequently becomes subject to tax under
36 this part or is a non-electing taxpayer that is subsequently proved
37 to be a member of the water's-edge group pursuant to a Franchise
38 Tax Board audit determination, as evidenced by a notice of



1 deficiency proposed to be assessed or a notice of tax change, shall
2 be deemed to have elected.

3 No water's-edge election shall be made for a taxable year
4 beginning prior to January 1, 1988.

5 (b) A water's-edge election may be terminated by a taxpayer
6 prior to the end of the 84-month period if either of the following
7 occurs:

8 (1) The taxpayer is acquired directly or indirectly by a
9 non-electing entity which alone or together with those affiliates
10 included in its combined report is larger than the taxpayer as
11 measured by equity capital.

12 (2) With the permission of the Franchise Tax Board.

13 (c) In granting a change of election, the Franchise Tax Board
14 shall impose any conditions that are necessary to prevent the
15 avoidance of tax or to clearly reflect income for the period the
16 election was, or was purported to be, in effect. These conditions
17 may include a requirement that income, including dividends paid
18 from income earned while a water's-edge election was in effect,
19 which would have been included in determining the income of the
20 taxpayer from sources within and without this state pursuant to
21 Section 25101 but for the water's-edge election shall be included
22 in income in the year in which the election is changed.

23 (d) If the taxpayer desires in any year not to renew the election,
24 the taxpayer shall serve written notice of nonrenewal upon the
25 board at least 90 days in advance of the annual renewal date.
26 Unless that written notice is provided to the board, the election
27 shall be considered renewed as provided in subdivision (a).

28 (e) If the taxpayer serves notice of intent in any year not to
29 renew the existing water's-edge election, that existing election
30 shall remain in effect for the balance of the period remaining since
31 the original election or the last renewal of the election, as the case
32 may be.

33 (f) *To the extent that a taxpayer would have been required to file*
34 *on a water's-edge basis in its first taxable year beginning on or*
35 *after January 1, 2000, pursuant to a water's-edge election made*
36 *in a prior year under this section, the terms of this section shall no*
37 *longer be applicable and the election shall be deemed to have been*
38 *made under the terms of Section 25113. However, the*
39 *commencement date of the election made in a prior year under this*
40 *section shall continue to be treated as the commencement date of*



1 *the water's-edge election period for purposes of applying Section*
2 *25113.*

3 SEC. 3. Section 25113 is added to the Revenue and Taxation
4 Code, to read:

5 25113. (a) Except as provided in subdivision (f), for taxable
6 years beginning on or after January 1, 2000, the election provided
7 for in Section 25110 shall be made on an original, timely filed
8 return for the year of the election. The election will be considered
9 valid if the conditions of both of the following are met:

10 (1) The tax is computed in a manner consistent with a
11 water's-edge election.

12 (2) A written notification of election is filed with the return on
13 a form prescribed by the Franchise Tax Board. Pursuant to
14 regulations issued under this section, the Franchise Tax Board may
15 accept the filing of other objective evidence that supports the
16 conclusion that a water's-edge election was intended in lieu of
17 notification on the designated form.

18 (b) Except as otherwise provided, a water's-edge election shall
19 be effective only if made by every member of the combined
20 reporting group (as originally self-assessed) that is subject to
21 taxation under this part.

22 (1) An election made on a group return of a combined reporting
23 group shall constitute an election by each taxpayer member
24 included in that group return, unless one of those taxpayers files
25 a separate return in which no election is made and paragraph (2)
26 does not apply.

27 (2) A taxpayer that fails to make an election on its own timely
28 filed original return shall be deemed to have elected if:

29 (A) It has a parent corporation that is an electing taxpayer that
30 included the income and apportionment factors of the nonelecting
31 taxpayer in the self-assessed combined reporting group reflected
32 in the electing parent's timely filed original return (including a
33 group return).

34 (B) The income and apportionment factors of the nonelecting
35 taxpayer are reflected in the combined reporting group of a timely
36 filed original return of an electing taxpayer, and the notification of
37 election filed by the electing taxpayer pursuant to paragraph (2) of
38 subdivision (a) is signed by an officer or other authorized agent of
39 either a parent corporation of the nonelecting taxpayer or another



1 corporation with authority to bind the nonelecting taxpayer in an
2 election.

3 (3) For purposes of this subdivision, a “parent corporation” of
4 the taxpayer is a corporation that owns or constructively owns
5 stock possessing more than 50 percent of the voting power of the
6 taxpayer as determined under subdivisions (e) and (f) of Section
7 25105.

8 (4) If a corporation that is a member of a combined reporting
9 group is not itself subject to taxation under this part in the year for
10 which the water’s-edge election is made, but subsequently
11 becomes subject to taxation under this part, that corporation shall
12 be deemed to have elected with the other taxpayer members of the
13 combined reporting group.

14 (5) A taxpayer that is engaged in more than one apportioning
15 trade or business as defined in paragraph (6) of subdivision (d) of
16 Section 25128 may make a separate election for each apportioning
17 trade or business.

18 (c) A water’s-edge election shall remain in effect or be
19 terminated in accordance with this subdivision.

20 (1) Except as otherwise provided in this subdivision, if one or
21 more electing taxpayer members of a combined reporting group
22 later become disaffiliated or otherwise cease to be included in the
23 combined reporting group, the water’s-edge election shall remain
24 in effect as to both the departing taxpayer members and any
25 remaining taxpayer members.

26 (2) If one or more electing taxpayers become a member of a
27 new combined reporting group consisting of one or more
28 nonelecting taxpayers, the nonelecting taxpayers shall be deemed
29 to have elected if the value of the total business assets of the
30 electing taxpayers’ unitary affiliate group before the change of
31 membership is larger than the value of the total business assets of
32 the remaining member of the unitary affiliate group after the
33 change. Otherwise, the water’s-edge election shall be
34 automatically terminated at the time of the change. For purposes
35 of applying paragraphs (9) and (10), the commencement date of
36 the deemed election shall be the same as the commencement date
37 of the electing taxpayers.

38 (3) If taxpayers filing under water’s-edge elections with
39 different commencement dates become members of a single
40 combined reporting group, the water’s-edge election of the



1 members of the new group for purposes of paragraphs (9) and (10)
2 shall be deemed to have the same commencement date as the
3 water's-edge election of the respective unitary affiliate group that
4 has the larger value of total business assets before the change of
5 membership.

6 (4) If one or more taxpayers with an election that has been
7 terminated under paragraphs (9) or (10) become members of a
8 combined reporting group with other taxpayers, all member of the
9 new group shall be deemed to have the same election status and
10 termination date as the members of the respective unitary affiliate
11 group with the larger value of total business assets before the
12 change of membership.

13 (5) (A) Except as provide in subparagraph (B), if one or more
14 electing taxpayers did not report their income and apportionment
15 factors as members of a combined reporting group with one or
16 more nonelecting taxpayers, and, pursuant to a Franchise Tax
17 Board audit determination, the nonelecting taxpayers are properly
18 in the same combined reporting group as the electing taxpayers,
19 the water's-edge election of the electing taxpayers shall remain in
20 effect and the nonelecting taxpayers shall be deemed to have made
21 a water's-edge election. The commencement date of the deemed
22 water's-edge election shall be the same as the commencement date
23 of the electing taxpayers.

24 (B) Subparagraph (A) shall not apply if the value of total
25 business assets of the electing taxpayers does not exceed the value
26 of total business assets of the nonelecting taxpayers.

27 (C) If the value of total business assets of the electing taxpayers
28 is equal to or less than the value of total business assets of the
29 nonelecting taxpayers, the water's-edge election of each electing
30 taxpayer is terminated as of the date the nonelecting taxpayers are,
31 pursuant to the audit determination described in subparagraph (A),
32 properly in the same combined reporting group as the electing
33 taxpayers.

34 (D) For purposes of applying the business asset test of this
35 paragraph, the business assets of other members of the unitary
36 affiliate group that are not taxpayers shall not be taken into
37 account.

38 (E) Notwithstanding subparagraph (A), nonelecting taxpayers
39 may not be deemed to have made a water's-edge election if the



1 Franchise Tax Board audit determination described in
2 subparagraph (A) is withdrawn or otherwise overturned.

3 (6) For purposes of paragraphs (2) through (5):

4 (A) “Business assets” are assets (other than stock of a member
5 of the unitary affiliate group) which are used in the apportioning
6 trade or business or would produce business income if sold.

7 Business assets shall be valued at net book value.

8 (B) The phrase “unitary affiliate group” refers to all of those
9 corporations that would constitute a unitary group if a
10 water’s-edge election were not made.

11 (7) In the application of paragraphs (2) to (4), inclusive, a series
12 of acquisitions as steps of a single transaction shall be aggregated
13 as a single change of membership.

14 (8) In the event of a merger or consolidation, the water’s-edge
15 status and election commencement date or termination date of the
16 surviving corporation shall be consistent with the result that would
17 have been obtained under paragraphs (2) to (4), inclusive, if the
18 surviving corporation had acquired the stock of the transferor
19 corporation.

20 (9) A water’s-edge election may be terminated without the
21 consent of the Franchise Tax Board after it has been in effect for
22 at least 84 months. The termination shall be made on an original,
23 timely filed return for the first year in which the water’s-edge
24 election is to be terminated. To be effective, the termination shall
25 be made by every taxpayer that is a member of the water’s-edge
26 group in the same manner as the election provided under
27 subdivisions (a) and (b).

28 (10) A water’s-edge election may be terminated before the
29 84-month period, described in subdivision (a), has elapsed, but
30 only with the consent of the Franchise Tax Board. A request for
31 termination shall be made in the time and manner specified by the
32 Franchise Tax Board. Such requests may be granted for good
33 cause. For purposes of this section, good cause shall have the same
34 meaning as specified in Section 1.1502-75(c) of Title 26 of the
35 Code of Federal Regulations.

36 (11) Except for deemed elections as provided in paragraphs (2),
37 (4), and (5), if a water’s-edge election is terminated under
38 paragraph (9) or (10), another election may not be made under this
39 section for any income year that begins within the 84-month period
40 after the last day of the election period that was terminated. The



1 Franchise Tax Board may waive the application of this prohibition
2 period for good cause.

3 (12) A water’s-edge election shall remain in effect until
4 terminated.

5 (d) For purposes of this section:

6 (1) A “combined reporting group” means those corporations
7 whose income and apportionment factors are considered pursuant
8 to this chapter in computing the income of the individual taxpayer
9 that is derived from or attributable to sources within this state.

10 (2) A “group return” refers to the single return which
11 taxpayers members of a combined reporting group may elect by
12 contract to file, in the form and manner prescribed by the Franchise
13 Tax Board, in lieu of filing their own respective returns.

14 (e) The Franchise Tax Board may prescribe any regulations as
15 may be necessary or appropriate to carry out the purposes of this
16 section.

17 (f) To the extent that a taxpayer would have been required to
18 file on a water’s-edge basis in its first income year beginning on
19 or after January 1, 2000, pursuant to a water’s-edge election made
20 in a prior year under Section 25111, the terms of Section 25111
21 shall no longer apply and that election shall be deemed to have
22 been made under the terms of this section. However, the
23 commencement date of the election made in a prior year under
24 Section 25111 shall continue to be treated as the commencement
25 date of the water’s-edge election period for purposes of applying
26 the provisions of this section.

27 SEC. 4. Section 25116 is added to the Revenue and Taxation
28 Code, to read:

29 25116. Notwithstanding paragraph (1) of subdivision (a) of
30 Section 23051.5, when provisions of this article refer to provisions
31 of the Internal Revenue Code that are not otherwise applicable for
32 purposes of Part 10.2 (commencing with Section 18401) or this
33 part, the term “Internal Revenue Code” means Title 26 of the
34 United States Code, including all amendments thereto, as in effect
35 for federal purposes for the taxable period, except as otherwise
36 specifically provided in this article.

37 SEC. 5. This act provides for a tax levy within the meaning of
38 Article IV of the Constitution and shall go into immediate effect.

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