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External Multistate Tax Alert
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CA CCR 2017-02: Acquisition goodwill included in deemed water's-edge election business asset test

Overview

The California Franchise Tax Board ("FTB") recently released Chief Counsel Ruling 2017-02[1] ("Ruling 2017-02"), which concluded that goodwill recorded as a result of a company's acquisition of a target group of companies should be included in the value of the total business assets of the target for purposes of applying the "deemed water's-edge election" business asset test under California Revenue & Taxation Code ("CRTC") Section 25113(c)(2). Based on that finding, the FTB then concluded that the acquirer (that, prior to the acquisition, had been filing on a worldwide basis) was deemed to have made a water's-edge election because the value of the business assets of the target (that, prior to acquisition, had been filing on a water's-edge basis) was greater than the value of the acquirer's business assets and thus, the target's filing methodology controlled.

This Tax Alert summarizes Ruling 2017-02 and provides some taxpayer considerations.

Factual background

A company ("Acquirer") operated in various states including California.[2] Acquirer purchased 100 percent of the issued share capital of a group of companies ("Target"), including the assumption of Target's liabilities. As a result, the newly combined company was renamed, and a new ultimate parent was created.[3] For purposes of this discussion, this newly combined company is collectively referred to as the "Company."

Consistent with financial accounting rules, upon acquisition, Target's assets were restated to fair market value.[4] The consolidated financial statement detail report recorded goodwill in a distinct column, instead of attributing goodwill to a specific legal entity.[5] Additionally, prior to the acquisition, Acquirer filed on a worldwide basis, and Target filed on a water's-edge basis.[6] Because the Company concluded that Acquirer and Target were unitary and that Acquirer's business assets had larger value than Target's, the Company determined that Acquirer's filing methodology controlled and thus, filed prospectively on a worldwide basis.[7]

In order to properly calculate its net operating losses, the Company sought FTB guidance on whether goodwill, recorded as a result of Acquirer's acquisition of Target, should be reflected in the total business assets of Target such that the value of Target's total business assets was greater than that of Acquirer, in which case Acquirer would be deemed to have made a water's-edge election under CRTC Section 25113(c)(2) when the new unitary affiliate group was established.[8]

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[1] Chief Counsel Ruling 2017-02 (Sept. 8, 2017), available here.
[2] Chief Counsel Ruling 2017-02 at 1.
[3] *Id.*
[4] *Id.* at 2.
[5] *Id.* Target's net book value of business assets, however, did include goodwill that resulted from the acquisition pursuant to the accounting rules promulgated by the International Financial Reporting Standards ("IFRS").
[6] *Id.*
[7] *Id.*
[8] *Id.* "New unitary affiliate group" means "a unitary affiliate 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 affiliate group. Cal. Rev. & Tax. Code § 25113(c)(6)(C); *see* Chief Counsel Ruling 2017-02 at 3. In Ruling 2017-02, the parties agreed that Acquirer and Target constituted a new unitary affiliate group.

Summary of the FTB's analysis in Ruling 2017-02

Generally, California law requires unitary groups to file on a worldwide combined basis, unless an election is made to file a water's-edge combined report.[9] California law addresses the effect of water's-edge elections as a result of corporate events (e.g., acquisitions, mergers, consolidations, or disaffiliations) between electing and non-electing affiliates after a valid election is made.[10] Specifically, CRTC Section 25113(c)(2), referred to as the business asset test, provides:

> If an electing taxpayer and a nonelecting taxpayer become members of a new unitary affiliate group, the nonelecting taxpayer shall be deemed to have elected if the value of the total business assets of the electing taxpayer, and its component unitary group, if any, is *larger* than the value of the total business assets of the nonelecting taxpayer, and its component unitary group, if any. Otherwise, the water's–edge election shall be automatically terminated at the time the electing members become part of the combined report. For purposes of applying paragraphs (9) and (10), the commencement date of the deemed election shall be the same as the commencement date of the electing taxpayers.[11]

In Ruling 2017-02, the FTB stated that the phrase "business assets" was defined to include "intangible assets, except the stock of a member of the unitary affiliate group, which is used in the conduct of the business of the unitary affiliate group."[12] Noting that this definition was broad and that there were no statutory or regulatory exceptions that specifically excluded goodwill from the definition of "business assets" for purposes of the business asset test, the FTB concluded that goodwill should be included.[13] The FTB further explained that goodwill was inseparable from, and thus must be attributed to, Target based on federal and California law which have recognized that goodwill was inseparable from a particular business' ongoing operations.[14]

The FTB then addressed the "value" that should be used in the business asset test. The FTB first stated that assets are valued at net book value as of the date the electing taxpayers and the non-electing taxpayers or non-taxpayers become members of a new unitary affiliate group.[15] The FTB then noted that "net book value" means:

> Net book value is equal to an asset's original cost minus depreciation, depletion and amortization. Book value means the amount which an asset is carried on a balance sheet….Book value…will be reflected using United States Generally Accepted Accounting Principles (US GAAP). If any member of a component unitary group does not maintain its books on US GAAP, the [FTB] may allow an alternative method of valuation of that members' business assets.[16]

The FTB stated that, "goodwill" is generally defined as "the excess of the purchase price of a company over its book value, which represents the value of goodwill as an intangible asset for accounting purposes."[17] Therefore, the FTB determined that, because US GAAP and the IFRS requires a determination of an impairment on an annual basis, in order to accurately reflect the value of goodwill for the business asset test, an impairment or other re-evaluation must be considered under US GAAP or an equivalent accounting method, which the Company represented that it had made to reflect the proper "net book value."[18]

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[9] *Id.* at 3. Generally, the election to file on a water's-edge basis and a taxpayer's termination of such election is binding for 84 months. *Id.*

[10] Cal. Rev. & Tax. Code § 25113(c); Cal. Code of Regs. § 25113; *see* Chief Counsel Ruling 2017-02 at 3.

[11] Cal. Rev. & Tax. Code § 25113(c)(2) (emphasis added); *see* Chief Counsel Ruling 2017-02 at 3.

[12] Chief Counsel Ruling 2017-02 at 3. CRTC Section 25113(c)(6)(A) defines the phrase "business assets" to include "intangible assets, other than stock of a member of the unitary affiliate group, which are used in the conduct of the business of the unitary affiliate group or would produce business income to the unitary affiliate group, if an election were not in place, if the assets were sold." Cal. Rev. & Tax. Code § 25113(c)(6)(A).

[13] *Id.*

[14] *Id.* at 4-5 (citing *Pfleghar Hardware Specialty Co. v. Blair*, 30 F.2d 614,616-17 (2d Cir. 1929); *Appeal of Borden*, 77-SBE-007 (Feb. 3, 1977) (quoting *Grace Bros. v. Commissioner*, 173 F.2d 170, 175-176 (9th Cir. 1949)).

[15] *Id.* at 3 (citing Cal. Code of Regs., tit. 18, § 25113(b)(10)).

[16] *Id.* at 2-3 (citing Cal. Code of Regs., tit. 18, § 25113(b)(5)).

[17] *Id.* at 4.

[18] *Id.*

Based on the above, the FTB concluded that, goodwill recorded as a result of Acquirer's acquisition of Target should be included as a business asset of Target for purposes of applying the "deemed water's-edge election" business asset test under CRTC Section 25113(c)(2).[19] The FTB then concluded that, because the value of Target's total business assets (including goodwill) was greater than that of Acquirer's when the new unitary affiliate group was established, Acquirer was deemed to have made a water's-edge election.[20]

Considerations

Chief Counsel Rulings are taxpayer-specific rulings that may only be relied upon by the taxpayer named in the ruling. However, they serve as guidance on how the FTB may potentially interpret the respective provisions in cases involving substantially similar or same facts. Specifically, Ruling 2017-02 appears to clarify that goodwill should be included when evaluating whether an electing or non-electing taxpayer has larger business assets for purposes of determining whether the non-electing taxpayer is deemed to have made a water's-edge election. Taxpayers engaged in or anticipating corporate re-organizations or acquisitions should consult with a California tax specialist to determine the proper application of CRTC Section 25113 and Regulation Section 25113.

Contacts:

If you have questions regarding Chief Counsel Ruling 2017-02 or other California tax matters, please contact any of the following Deloitte Tax professionals:

Christopher Campbell
Principal, California Technical/Controversy Lead
Deloitte Tax LLP, Los Angeles
+1 213 553 3072
cwcampbell@deloitte.com

Steve West
Managing Director, California Technical Lead
Deloitte Tax LLP, Los Angeles
+1 213 688 5339
stevewest@deloitte.com

Brian Toman
Special Advisor, California Technical/Controversy Lead
Deloitte Tax LLP, San Francisco
+1 415 783 6137
btoman@deloitte.com

Bart Baer
Principal
Deloitte Tax LLP, San Francisco
+1 415 783 6090
bartbaer@deloitte.com

Tony Pollock
Managing Director
Deloitte Tax LLP, San Diego
+1 619 237 6516
tonypollock@deloitte.com

Shirley J. Wei
Senior Manager, California Technical/Controversy Lead
Deloitte Tax LLP, Los Angeles
+1 213 553 1715
shiwei@deloitte.com

Valerie C. Dickerson
Partner, Washington National Tax
Deloitte Tax LLP, Washington DC
+1 202 220 2693
vdickerson@deloitte.com

The authors of this alert would like to acknowledge the contributions of George Dulgeryan and Ryan Potter to the drafting process. George is a Tax Senior and Ryan is a Tax Consultant. They both work in the Los Angeles Multistate Tax practice of Deloitte Tax LLP.

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[19] *Id.* at 5.
[20] *Id.*

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