

Foreign Entity's 2015 Taxable Year California Water's-edge Election - October 17 Due Date

Overview

Unitary foreign affiliates that are "doing business" in California for taxable year 2015 under California's economic nexus standard, and that are not eligible to apply California Franchise Tax Board (FTB) Notice 2016-02,¹ must file standalone California corporate franchise/income tax returns for taxable year 2015 and make their own water's-edge election. Failure to do so may potentially expose the worldwide group to California franchise/income tax. For taxpayers that are required to file their 2015 California tax returns by October 17, 2016, such standalone returns must be filed by that same date.

Background on Notice 2016-02

Notice 2016-02 (the "Notice") provides guidance on how the FTB would treat an otherwise valid water's edge election when a non-electing unitary foreign affiliate of a water's-edge combined group becomes a "taxpayer" because it is "doing business" in California solely as a result of applying the economic nexus standard under California Revenue and Taxation Code (CRT) section 23101(b), which became effective for taxable years beginning January 1, 2011.² Under California's economic nexus standard, taxpayers with sales into California in excess of the applicable threshold (e.g., for 2015, the lesser of \$536,446 or 25% of the taxpayer's total sales) are "doing business" in California and thus required to file a California corporate franchise/income tax return.³

In general, if a unitary foreign affiliate is eligible to apply the Notice, then it will be deemed to have made a water's edge election along with the original members of the water's edge group. However, the Notice only applies in three specific situations, in each case provided that four conditions are met. Accordingly, the Notice does not apply to all potential situations—i.e., there are some situations for which a unitary foreign affiliate will not be deemed to have made a water's edge election with the original water's edge group. We have identified two such situations, one of which may impact taxpayers preparing returns due on October 17, 2016: (1) if the water's-edge combined group made a water's edge election in taxable years 2011 or after, and at the time of the election, the unitary foreign affiliate was subject to California tax because it met California's economic nexus standard, or (2) the unitary foreign affiliate becomes a California taxpayer due solely to California's economic nexus standard in taxable year 2017 or after.⁴ In these two situations, the unitary foreign affiliate will not be deemed to have made a water's edge election along with the original water's edge group. Instead, it must file a separate return, make its own water's edge election, and pay the \$800 minimum franchise tax.

In sum, a unitary foreign affiliate that becomes a California taxpayer under California's economic nexus standard, and that is not deemed to have made a water's edge election with the original water's edge group under the Notice, must file a separate California tax return, make its own water's-edge election, and pay the \$800 minimum franchise tax.

Considerations

Given the variances that may exist in an organization's foreign operating structure, a case-by-case review is recommended to determine if each unitary foreign affiliate is "doing business" in California and, if so, whether or not Notice 2016-02 applies to treat the unitary foreign affiliate as having made a water's edge election with the original water's edge group. For taxpayers that do qualify to apply the Notice, consideration should be given to filing amended returns for prior years to apply the Notice to deem the unitary foreign affiliate to have elected water's-edge with the original water's-edge group.

¹ Franchise Tax Board Notice 2016-02 (Sept. 9, 2016). Available [here](#).

² *Id.*

³ Cal. Rev. & Tax Code § 23101(b).

⁴ *Id.*

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