

California Legislature Allows Certain Non-U.S. Affiliates to Deem to Elect Water's Edge

Overview

On September 29, 2020, Governor Newsom signed Assembly Bill ("A.B.") 3372 into California law. A.B. 3372 made several changes to California's tax laws, the most notable of which allows unitary, non-U.S. affiliates that become California taxpayers solely due to California's economic nexus standard in a taxable year beginning on or after January 1, 2021, to be deemed to have made a water's edge election with the existing water's edge combined reporting group.¹

This Tax Alert provides some background on this issue, summarizes the change made by A.B. 3372 to California's water's edge election rules, and provides some taxpayer considerations.

Background on Foreign Affiliate Deemed Water's Edge Election Rules

Corporations that are "doing business" in California for the taxable year are subject to California's Corporation Franchise Tax.² For taxable years beginning on or after January 1, 2011, California revised the definition of "doing business" under California Revenue and Taxation Code ("CRTC") section 23101 to add subsection (b), which includes an economic nexus standard.³ Specifically, under CRTC section 23101(b), a taxpayer is doing business in California for taxable year 2020 if any of the following conditions have been satisfied:

- The taxpayer is organized or commercially domiciled in California;
- Sales, as defined in CRTC section 25120 (e) or (f), of the taxpayer in California exceed the lesser of \$610,395, or 25 percent of the taxpayer's total sales;
- Real and tangible personal property of the taxpayer in California exceed the lesser of \$61,040, or 25 percent of the taxpayer's total real property and tangible personal property; or
- The amount paid by taxpayer in California for compensation, as defined in CRTC section 25120(c), exceeds the lesser of \$61,040, or 25 percent of total compensation paid by the taxpayer.⁴

Under California's Corporation Tax Law, corporations can elect to determine their income derived from or attributable to sources within California on a "water's edge" combined reporting basis (in lieu of the default worldwide combined reporting method).⁵ To have a valid water's edge election, various requirements must be satisfied, including that every member of the combined reporting group that is subject to California tax must make the water's edge election.⁶

CRTC section 25113 and the underlying regulations provide for a deemed election in certain circumstances, pursuant to which a California taxpayer is deemed to have made a valid water's edge election with an existing water's edge combined reporting group.⁷ The statute and regulations also address the effect of changes in the composition of the water's edge combined reporting group due to disaffiliations, mergers, acquisitions, and consolidations on a water's edge election.⁸

¹ A.B. 3722, 2019-2020 REG. SESS. (CAL. 2020) (available [here](#)).

² CAL. REV. & TAX CODE §§ 23151, 23151.1.

³ CAL. REV. & TAX CODE § 23101(b). Prior to the amendments to CRTC section 23101, "doing business" was defined only as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." CAL. REV. & TAX CODE § 23101(a).

⁴ CAL. REV. & TAX CODE § 23101(b); FTB Tax News, October 2020, "Doing business in California threshold amounts updated for 2020." The threshold amount of sales, real/tangible personal property, and compensation used under CRTC section 23101(b) is adjusted each year for inflation. The numbers reflected above are only for taxable year 2020.

⁵ CAL. REV. & TAX CODE § 25110.

⁶ CAL. REV. & TAX CODE § 25113(b) (2020).

⁷ See, e.g., CAL. REV. & TAX CODE § 25113(b)(2) (2020).

⁸ See, e.g., CAL. REV. & TAX CODE § 25133(c) (2020).

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As a result of California's incorporation of an economic nexus standard for the definition of "doing business," more non-U.S. affiliates are now subject to California's Corporation Franchise Tax—by making sales into California that exceed the applicable dollar threshold. However, before A.B. 3372, CRTC section 25113 did not provide a mechanism by which such unitary, non-U.S. affiliates could be deemed to make a water's edge election with the existing water's edge combined reporting group. Moreover, CRTC section 25113 and the underlying regulations provided rules that would terminate a water's edge election in some instances when an entity should have been included in the existing water's edge combined reporting group, but instead was excluded.⁹

To address this situation, the FTB issued a number of Notices, the latest being FTB Notice 2019-02, which allowed unitary, non-U.S. affiliates that become California taxpayers solely due to CRTC section 23101(b) in a taxable year beginning on or before December 31, 2020, to be deemed to have made a water's edge election with the existing water's edge combined reporting group, provided certain requirements stated in the Notice were satisfied.¹⁰

Overview of Change Made by A.B. 3372 to California's Water's Edge Election Rules

A.B. 3372 "prevent[s] an unintended consequence related to the water's edge election when a non-electing unitary foreign affiliate subsequently changes status from a non-taxpayer to a California taxpayer because of the revised definition of 'doing business.'"¹¹ Effective for taxable years beginning on or after January 1, 2021, A.B. 3372 adds new subsection (b)(5) to CRTC section 25113, which states:

If a unitary corporation not incorporated in the United States that is not itself subject to taxation under this part in the year for which the valid water's-edge election is made, but subsequently becomes subject to taxation under this part solely due to subdivision (b) of [CRTC] Section 23101 in a taxable year beginning on or after January 1, 2021, that corporation shall be deemed to have elected with the other members of the unitary combined reporting group.

Considerations

A.B. 3372 effectively codifies the deemed water's election treatment provided by the FTB in FTB Notice 2019-02. For taxable years beginning on or after January 1, 2021, a unitary, non-U.S. affiliate that becomes subject to California's Corporation Franchise Tax solely due to CRTC section 23101(b) is deemed to have made a water's edge election with the existing water's edge combined reporting group. For years before January 1, 2021, taxpayers can rely on FTB Notice 2019-02 to provide for similar treatment, provided the requirements set forth in Notice 2019-02 are satisfied. Water's edge combined reporting groups with one or more non-U.S. affiliates that may meet the economic nexus threshold for "doing business" in CRTC section 23101(b) in a taxable year beginning on or after January 1, 2021, should consult with their California tax advisors regarding the changes made by A.B. 3372 and how these changes may impact their California tax liabilities.

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⁹ See, e.g., CAL. REV. & TAX CODE § 25113(c)(2), (5); CAL. CODE OF REGS., TIT. 18, § 25113(c)(2)(A)4, (d)(3), (f)(2)(C).

¹⁰ See FTB Notice 2016-02 (June 26, 2019); see also FTB Notice 2016-02 (Sept. 9, 2016) and FTB Notice 2017-04 (Oct. 16, 2017) for prior Notices providing for the same treatment.

¹¹ Senate Committee on Governance and Finance Legislative Analysis for A.B. 3372, dated 7/24/2020 (available [here](#)).

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