Water’s-Edge Issues to Watch

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Water’s-edge combined reporting appears firmly rooted in multistate corporate franchise income tax law, but anomalies can be expected. For example, Alaska requires worldwide combined reporting, but only for oil and gas corporations. Montana has repeatedly considered legislation to return to worldwide combined reporting, with a bill pending. The California State Auditor has recommended that the state abandon the water’s-edge election and adopt a mandatory water’s-edge combination. Indeed, pending California legislation would remove the water’s-edge election for the tax year beginning on or after January 1, 2017, and specify that existing electors would be unable to file using the water’s-edge election for taxable years beginning on or after January 1, 2023.

Assuming a water’s-edge method to be the rule, the issue then becomes setting the parameters of that group. On June 27, 1983, the U.S. Supreme Court’s Container decision upheld the states’ use of mandatory worldwide combined reporting. However, as a result of political concerns, especially international political concerns, a movement quickly began in the aftermath of Container to create a water’s-edge alternative. Accordingly, on September 23, 1983, President Reagan created, under the Treasury Secretary, the Worldwide Unitary Taxation Working Group. The working group was “charged with producing recommendations . . . that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states.” Its final report, issued in August 1984, announced that the working group — consisting of state and business representatives — reached agreement on principles such as a water’s-edge (not worldwide) unitary combination for both U.S. and foreign-based companies. However, the working group was unable to agree on the provisions of the proposed law.

1 Instruction for Form 6100 and Form 6150 Filed Under 15 ACC 20.421(c), 2016 Alaska Oil and Gas Corporation Net Income Tax Return, page 3.
2 Current S.B. 105 would repeal the water’s-edge election. Similar bills have been introduced — unsuccessfully — in prior sessions, e.g., S.B. 209 in the 2013 Legislative Session.
7 Id. at 3-4.
8 Id. at ii.
unable to reach agreement on specific issues regarding the composition of the water’s-edge group. One of those unresolved issues was the proper state tax treatment of U.S.-based corporations operating primarily abroad, or so-called 80/20 corporations. To this day, 80/20 corporations present a number of issues in the context of a water’s-edge election.

The 80/20 corporation definition considered by the working group referred to U.S. corporations with at least 80 percent of their payroll and property outside the United States. This definition differs from the one used by the federal government for federal income tax purposes, which is based on the percentage of foreign income measured by federal source rules — that is, whether at least 80 percent of the gross income from all of the corporation’s sources is “active foreign business income,” as defined. A division occurred within the working group between state representatives who believed that all U.S. corporations should be treated as within the water’s edge, and business representatives who believed that U.S. corporations with more than 80 percent of their business activities outside the United States, measured by payroll and property, should be excluded from the water’s-edge group. The final report concluded that this issue remained to be decided “on a state-by-state basis.” That division was ultimately addressed by individual state legislatures that enacted water’s-edge legislation — often with differing results.

California and FTB Legal Ruling 2016-02

After legislative wrangling, California in 1986 enacted its first water’s-edge legislation, which contained an 80/20 provision providing that the water’s-edge group includes “any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.” Curiously, this 80/20 three-factor average calculation dating to 1986 survives to this day, despite subsequent legislative changes to hyper-weight the sales factor, with most corporations now required for taxable years beginning after January 1, 2013, to apportion using one factor: single-factor sales.

California’s water’s-edge remains elective. A qualified taxpayer subject to California’s corporation franchise tax may elect to determine its income derived from or attributable to sources in the state under a water’s-edge election, typically for an initial term of 84 months. One requirement for making the water’s-edge election, with worldwide combined reporting being the default filing position, is that an election is effective “only if made by every member of the self-assessed

14. Almost immediately following the Working Group’s report, a number of states enacted water’s-edge legislation. In California, however, worldwide combination was more long lived. For many years prior to 1984, legislation opposed to worldwide combination had been introduced in California each legislative session. In the 1984 session, such legislation did not fare well again, but it became clear that some sort of water’s-edge reform would be enacted soon. 1985 legislation, which would have permitted a water’s-edge election, came very close to passage, but failed in the final hours of the session. In 1986, the proponents of water’s-edge finally broke through, enacting SB 85. (Stats. 1986, Chapter 660.) California Franchise Tax Board, Water’s-Edge Manual, Ch. 1.2 (Jan. 2004).
17. See FTB Legal Ruling 95-5 (Oct. 13, 1995), ruling that inclusion of an 80/20 corporation under this provision “is based upon the simple average of the payroll, property and sales factors” — and this calculation “is not affected” by the 1993 amendments that provided for an apportionment formula that double-weighted the sales factor in the three-factor apportionment formula. The 80/20 calculation also apparently was not affected by later amendments requiring most taxpayer to use single-sales-factor apportionment. See Franchise Tax Board Form 100W Booklet 2016, p. 11, stating the 80/20 determination is based on “the average of the property, payroll, and sales factors.”

9. Id.
10. Id. at 14.
11. IRC section 871(l)(1)(B).
12. Supra note 6, at 14-15.
13. Id. at 10.
combined reporting group that is subject to taxation under this part.20 A problem arose under this requirement when the State Legislature amended its section 23101 “doing business” statute to provide that for taxable years beginning on or after January 1, 2011, a corporation is doing business in California even in the absence of any physical presence in the state if it meets factor presence standards.21 For example, even without physical presence, California sales of more than $500,000 for a taxable year now constitute doing business.22 The FTB and practitioners soon took notice of the problem created in which a member of the unitary group did not and could not itself have made the election at the time the election was made (on an original return) because that member was not subject to tax in California at that time, but after the factor presence amendment of section 23101 would have been required to make the election to make that election effective.

The California water’s-edge law contains a number of provisions where changes to the composition of the unitary group after the making of an election will not invalidate that election. For example, a corporation that is a “non-electing taxpayer” later proved to be a member of the water’s-edge group under an FTB audit determination shall be deemed to have elected if the value of the total business assets of the electing taxpayers is greater than those of the non-electing taxpayers.23 However, the FTB took the position that neither the statutory scheme nor its regulations addressed the effect on an otherwise valid election attributable entirely to a change of law resulting in a change of status of a nonelecting unitary foreign affiliate from nontaxpayer to taxpayer.24 Addressing the scenario involving the addition of a factor presence nexus standard,25 the FTB concluded in FTB Notice 2016-02 that if specific conditions are met, it would not seek to terminate the election of the water’s-edge combined reporting group including a foreign affiliate that only became a factor presence taxpayer after the date of the election.

While the situation addressed in Notice 2016-02 is not unique to 80/20 corporations in the water’s-edge context, the issue certainly has a potential impact in the context of 80/20 corporations. Applying factor presence nexus standards in California has been further complicated by the state moving to market sourcing for income years on or after January 1, 2013,26 and those market sourcing rules can have a dramatic impact on when a sale of other than tangible personal property constitutes a California (that is, numerator) sale. Further complicating this analysis is the fact that FTB’s market sourcing regulations are an ongoing process. Thus, the factor presence nexus standard and the market sourcing rules can interact in combination to affect the California “taxpayer” issue involving an 80/20 corporation and the possible validity of a water’s-edge election as explained in Notice 2016-02 involving that corporation. The combination of the factor presence standard and market sourcing rules also may affect the 80/20 classification itself. Recall the 80/20 determination under California law is based on 20 percent or more factors in the United States,

20 Cal. Rev. & Tax. Code section 25113(b) (emphasis added).
24 FTB Notice 2016-02 (Sept. 9, 2016) at 2.
25 The four conditions are: 1) a group of taxpayers made a valid water’s-edge election prior to September 9, 2016; (2) a unitary foreign affiliate of that electing water’s-edge combined reporting group could not at that time make the election because it was not subject to tax in California at the time of the election; (3) the foreign affiliate was unitary with the electing water’s-edge combined reporting from the date of the election to the date the foreign affiliate became a California taxpayer; and (4) the foreign affiliate became a California taxpayer in a tax year ending on or before December 31, 2016, solely because it satisfied the (new) factor-presence nexus standard in section 23101(b). FTB Notice 2016-02, at 3.
not California.\textsuperscript{27} That 20 percent metric is generally the sum of the percentage calculated for each factor under the individual state rules,\textsuperscript{28} so changes in state law — such as California’s — may change the mathematics of the 80/20 calculation.

Even after Notice 2016-02, continuing uncertainty in the area suggests legislative action may be prudent. Despite that notice, there is no clear statutory or regulatory language addressing these issues, and an FTB notice provides less-than-authoritative guidance. Further, the notice only applies to nexus acquired in a taxable year ending on or before December 31, 2016, thus leaving no guidance for the future. Although no legislation has been introduced as of this writing, it has been suggested.\textsuperscript{29}

\textbf{Agilent From Colorado}

Unlike California, Colorado requires affiliated C corporations to file a (mandatory) water’s-edge combined corporate income tax report if they meet a statutory unitary business test.\textsuperscript{30} Like California, Colorado also provides for an 80/20 test to determine when a C corporation is included in the combined report.\textsuperscript{31} However, Colorado defines an 80/20 corporation using not a three, but a two-factor metric, and only looks to the property and payroll factors assigned to locations inside the United States.\textsuperscript{32}

In \textit{Agilent Technologies Inc. v. Department of Revenue of Colorado},\textsuperscript{33} the Colorado District Court recently considered the issue of when a C corporation is included in the combined report under the 80/20 test.\textsuperscript{34} The Colorado DOR argued that Agilent Technologies Inc., a corporate parent of a worldwide group of affiliated corporations doing business in Colorado, should include its holding company, Agilent Technologies World Trade Inc., in its unitary combined corporate income tax report in Colorado.\textsuperscript{35} During the years at issue, World Trade owned and derived all of its income from investments in foreign entities that conducted business entirely outside the United States and were disregarded as separate legal entities under the federal check-the-box elections.\textsuperscript{36} World Trade did not have any property or payroll in Colorado or elsewhere.\textsuperscript{37}

Under Colorado’s 80/20 test, a C corporation must have more than 20 percent of its property and payroll assigned to locations inside the United States to be included in the Colorado combined report.\textsuperscript{38} The DOR argued that despite World Trade having no property or payroll factors of its own, it met the definition of an includable C corporation through its use of Agilent’s property and payroll.\textsuperscript{39} The court disagreed, pointing to Colo. Code Regs. 39-22-303.12(c), which provided

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\item \textsuperscript{27} Issues may also arise because the United States is not uniformly defined among the 80/20 states. For example, in Colorado and New Hampshire, United States is defined as the 50 states and the District of Columbia. Colo. Stat. section 39-22-303(8); N.H. Rev. Stat. section 77-A:1, XIX. However, in Texas, the definition of United States also includes “the territorial waters of the United States” and “the possessions and territories of the United States and the Commonwealth of Puerto Rico.” Tex. Admin. Code 3.590(b)(7). Therefore, a company with 80 percent or more of its payroll and property in Puerto Rico or another territory or possession of the United States would be excluded from the combined return in Colorado and New Hampshire, but included in the combined return in Texas.
\item \textsuperscript{28} Cal. Code Regs. tit. 18 section 25110(d)(2)(B).
\item \textsuperscript{30} Colo. Code Regs. 39-22-303.11(a); see also, Colo. Rev. Stat. section 39-22-303(11) (requiring that the combined report includes only those members of an affiliated group of C corporations that meet three or more parts of a six-part unitary business test for the current and two preceding years).
\item \textsuperscript{31} See, Colo. Rev. Stat. section 39-22-303(12)(c) (defining an “includable C corporation” for purposes of the combined report as “any C corporation which has more than twenty percent of the C corporation’s property and payroll . . . assigned to locations inside the United States”); and see also, Colo. Rev. Stat. section 39-22-303(8): “The executive director shall not require the inclusion in a combined report of the income of any C corporation which has more than twenty percent of the C corporation’s property and payroll . . . assigned to locations inside the United States.”
\item \textsuperscript{32} Id.
\item \textsuperscript{33} No. 2014CV393 (Denver Dist. Ct. Jan. 20, 2016).
\item \textsuperscript{34} Id.
\item \textsuperscript{35} Id.
\item \textsuperscript{36} Id.
\item \textsuperscript{37} Id.
\item \textsuperscript{38} Id.
\item \textsuperscript{39} Agilent Technologies Inc., No. 2014CV393 (Denver Dist. Ct. Jan. 20, 2016) at 9.
\end{itemize}
that a corporation with no property or payroll factors of its own cannot have 20 percent or more of its factors assigned to locations in the United States and that “such corporations, by definition, cannot be included in a combined report.” The court held that a contrary finding would conflict with current Colorado law and legislative intent. However, a day before filing this case, the DOR issued a notice stating that until further notice is provided, taxpayers should not rely on Colo. Code Regs. 39-22-303.12(c), except as it applies to a foreign sales corporation.

Agilent’s alternative (albeit failed) argument was that because World Trade and its subsidiaries were treated as a single C corporation on its federal return under the federal check-the-box regulations, it should also be treated as a single C corporation for Colorado purposes and, therefore, World Trade qualifies as an excludable 80/20 corporation because — taking into account its foreign subsidiaries — greater than 80 percent of its property and payroll fall outside of the United States. Although the court agreed that World Trade was a C corporation, it did not agree that the subsidiaries should be disregarded for the purpose of Colorado’s combination rules simply because the subsidiaries were disregarded for federal tax purposes, since nothing in the Colorado statutes required treating World Trade and its subsidiaries according to their own check-the-box designations. Also, the court provided that the federal check-the-box rules and the combined reporting rules served different purposes; thus, an entity’s choice of federal designation is not binding for Colorado combination purposes. Further, the court noted that the federal check-the-box elections could create “an opportunity for an entity to sidestep application of [the statutory unitary business test] by subjectively defining itself.”

Agilent sheds light on the differing interpretation of 80/20 corporations among the states. For Colorado purposes, it appears that the determination whether an entity is an 80/20 corporation is made on an entity-by-entity basis and that flow-through attributes from entities treated as disregarded for federal tax purposes may not be included.

**Ashland From Minnesota**

Minnesota does not have an 80/20 provision. Rather, it provides for an “all or nothing” inclusion of the income and factors of foreign corporations or entities in the combined corporate franchise tax report.

Unlike the Agilent court’s holding that Colorado did not have to respect the taxpayer’s federal check-the-box elections, the court in Ashland Inc. v. Commissioner of Revenue respected
the taxpayer’s federal check-the-box elections for the purpose of determining which entities were included in its Minnesota combined franchise tax reports. In this case, the taxpayer, Ashland Inc., owned 100 percent of Hercules Inc., which wholly owned Hercules Investments SARL, a foreign entity organized under the laws of Luxembourg. Under the federal check-the-box regulations, Hercules Sarl elected to be treated as a disregarded entity for federal tax purposes. Hercules, therefore, reported Hercules Sarl’s income, losses, and deductions as its own and Ashland included Hercules in its Minnesota combined report for the tax years at issue.

The commissioner of revenue later determined that the items included on Ashland’s Minnesota combined report flowing from Hercules Sarl were improperly included, because the Minnesota statute at the time did not permit the net income of “foreign corporations or foreign entities” to be included in a combined report — even though they may be part of a unitary business. Net income for Minnesota purposes is federal taxable income as defined in the Internal Revenue Code incorporating “any elections made by the taxpayer in accordance with the Internal Revenue Code in determining federal taxable income for federal income tax purposes” subject to modifications articulated under the Minnesota statutes.

The court disagreed with the commissioner and held that because Hercules Sarl elected to be treated as a disregarded entity (foreign or otherwise), it was treated as one with its parent Hercules for federal income tax purposes, and by extension for Minnesota income tax purposes. Therefore, Hercules Sarl’s income and apportionment factors were not those of a foreign entity. Rather, they were those of its domestic parent, Hercules, since Hercules Sarl was not treated as an entity at all. Under both federal and Minnesota law, Hercules Sarl was deemed to have liquidated into its corporate domestic parent under the federal check-the-box regulations. The court declined to defer to Minnesota’s “long standing position” under Revenue Notice 98-08 not to recognize the federal check-the-box elections made by a foreign entity with a single C corporation owner that elected to be disregarded as a separate entity for foreign tax purposes, since revenue notices do not have the force of law.

The court noted the significance of the taxpayer’s election to treat Hercules Sarl as a disregarded entity for federal tax purposes. The court distinguished the facts here from that in Manpower Inc. v. Commissioner of Revenue, under which the Minnesota Supreme Court required the exclusion of the foreign subsidiary from the Minnesota combined report. Under Manpower, the taxpayer was a majority (not sole) shareholder of a foreign corporation that elected to be treated as a partnership for federal income tax purposes. The Manpower court held that the subsidiary was a foreign entity because under its federal election to be treated as a partnership, the entity remained an entity separate and distinct from its shareholders. Under the federal regulations, and by extension under Minnesota law, the foreign subsidiary was deemed to have distributed all of its assets and liabilities to its shareholders. And immediately thereafter, the shareholders were deemed to have contributed all of the distributed

57 Id. at 10-11.
58 Id. at 11 (citing Treas. Reg. section 301.7701-3(g)(1)(iii)).
59 724 N.W.2d 526 (Minn. 2006).
60 Id. at 531-32.
61 Id. at 527.
62 See id. at 531-32 (holding that the foreign subsidiaries federal check-the-box election to be treated as a partnership did not result in the foreign subsidiary being a domestic entity within the meaning of Minn. Stat. section 290.01, subd. 5, and as a result, Manpower could not include the foreign entity’s net income and apportionment factors in its Minnesota income tax return).
63 Id.
assets and liabilities to a newly formed partnership. Here, in contrast, Hercules Sarl was deemed to have distributed all of its assets and liabilities to its sole shareholder, Hercules, in liquidation of the association. Therefore, the court held that Manpower did not govern, except to the extent that it demonstrated that “federal elections — and the effects deemed to flow from them — must be recognized under Minnesota law.”

Ashland illustrates that unlike Colorado, Minnesota courts will respect the federal check-the-box elections to determine which entities are included in the unitary combined report. However, this decision only applies to tax years before 2013. That year the Minnesota statute at issue was amended to include in the unitary combined franchise tax reports the income and apportionment factors of foreign entities that are disregarded for federal income tax purposes, other than an entity treated as a C corporation. After the change in law, the DOR issued a revenue notice stating that for Minnesota corporate franchise tax purposes, the DOR will follow the elections made by eligible domestic and foreign entities under the federal check-the-box regulations.

Target From Colorado

Finally, the Colorado District Court’s recent decision in Target Brands Inc. v. Department of Revenue is interesting on the issue of apportionment for an 80/20 corporation. Target had formed TBI as a wholly owned subsidiary that was 100 percent devoted to brand protection and management. The court easily found that TBI was not a sham entity, had economic substance, and was properly formed and operated for legitimate business purposes. Moreover, the Colorado DOR did not challenge the royalty rate paid to TBI. And unlike Agilent, there was no issue over whether TBI met the Colorado statutory definition of an 80/20 corporation — that is, an affiliated corporation with more than 20 percent of its property and payroll assigned to locations within the United States. Instead, the issues involved nexus and apportionment.

The first issue before the court was whether Colorado had statutory and constitutional authority to tax TBI, which did not have any physical presence in Colorado during the years in issue. However, TBI received substantial (royalty) income based on Target’s sales in Colorado. After noting that doing business was not defined by Colorado statute for the years at issue, and that doing business regarding licensors of intangible property was not even defined by the department’s regulations for the years at issue, the court still concluded that TBI was doing business in Colorado. The court stated that TBI had chosen to license its IP for use by Target in Colorado and had “received hundreds of millions of dollars in income related to its use of its IP in Colorado.”

While acknowledging Quill’s physical presence nexus standard, the court concluded that the commerce clause does not require physical presence to establish “substantial nexus” for income tax purposes and that TBI had economic nexus in the state as a result of its licensing activities.

The court then turned to the most interesting legal issue: apportionment for the 80/20 corporation. During most years at issue, a Colorado statute provided for use of an equally weighted three-factor formula of payroll, property, and sales. (For one year at issue, the statute provided for single-sales-factor

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66 Id.
67 Ashland Inc., No. 08819-R at 9-10 (citing Treas. Reg. section 301.7701-3(g)(1)(iii)).
69 Minn. Stat. section 290.17, as amended Laws 2013, c. 143, art. 6 section 28, effective January 1, 2013 (providing that the net income and apportionment factors of “foreign corporations and other foreign entities which are part of a unitary business shall not be included in the net income or the apportionment factors of the unitary business; except that the income and apportionment factors of a foreign entity, other than an entity treated as a C corporation for federal income tax purposes, that are included in federal taxable income . . . of a domestic corporation, domestic entity, or individual must be included in determining net income and factors used in the apportionment of net income”).
70 Minnesota Department of Revenue, Revenue Notice 13-08 (Dec. 23, 2013).
73 Op. at 64.
apportionment.) There was no dispute that each of TBI’s payroll, property, and sales factors — if computed under the Colorado law in effect at the time — would have sourced none of TBI’s income to Colorado. (There were no Colorado employees, no Colorado property, and no Colorado sales under the applicable costs of performance standard — not market sourcing — in effect at that time.) Unsurprisingly, the DOR invoked the Colorado statute modeled on section 18 of the Uniform Division of Income for Tax Purposes Act to use a different apportionment formula. The court agreed that the department had demonstrated that the standard apportionment formula did not fairly represent TBI’s business activity in Colorado because the standard formula did not account for “the manner in which TBI’s income is generated and where the income-generating activity occurs.”75 The court pointed out that application of either the standard three-factor formula or a single sales factor would result in TBI owing no income tax to Colorado despite receiving hundreds of millions of dollars based on royalties from sales in Colorado.

But while the court agreed that use of an alternative formula was appropriate, it disagreed with the DOR’s proposed alternative apportionment formula: eliminate all three of TBI’s factors (payroll, property, and sales) and instead use a single new factor — the sales factor of TBI’s parent, Target — to apportion TBI’s income. By the plain terms of section 18, the court said, the alternative selected must be “reasonable.”76 Here, the court found that TBI’s employees and real and tangible assets (all outside Colorado) made material contributions toward creating, enhancing, and preserving the income the DOR sought to tax. Accordingly, omitting these factors was neither reasonable nor equitable, according to the court, which then concluded that it was necessary to include TBI’s payroll and property in an alternative formula under section 18. The court then ordered the DOR to include TBI’s payroll and property factors in its apportionment formula. Here, the DOR respected TBI’s payroll and property for classifying it as an 80/20 corporation, but then disregarded that same property and payroll for purposes of its alternative apportionment method.

Conclusion

As illustrated by these recent developments, water’s-edge combination issues involving 80/20 definitional and apportionment issues continue to present challenges. As states continue to seek additional revenue, one can only expect further litigation in this area.

75 Op. at 81.
76 Op. at 82.