CalTax Fact Sheet:
The Role of the Water’s Edge Election in California's Worldwide Unitary Taxation Method

Brief History

The most difficult aspect of briefly explaining the history and general purpose of the water's edge election is trying to convey the level of outrage that existed among California's foreign trading partners because of our method of taxing multinational companies prior to the adoption of the water's edge election. At the time, Britain, Japan, Canada and others were clamoring about California's method of taxing multinational companies, and were calling for significant retaliatory actions absent corrective measure, which ultimately worked out to be the water's edge election.

The theory of "unitary taxation" derives from the idea that corporations should be taxed roughly equivalently whether they are arranged as a single legal entity with divisions or as separate affiliated legal entities. Grouping legally separate entities together for purposes of taxation is commonly referred to as a "unitary group" or "combined group." You also might hear reference to the "combined report," which in essence is the process by which a unitary group of companies report their combined income for purposes of California taxation. A "combined report," however, is not a "consolidated return" that the Feds use (literally a single return for all the affiliated companies). With a combined report, each individual legal entity must continue to file separate tax returns and pay its share of California income taxes. That share is calculated by determining each company's "apportionment factor" (a ratio which is the sum of 2 times its California sales, plus California payroll and California property divided by the group's total sales, payroll and property).

The combined report (the unitary method) dates back to roughly the time when California began imposing the corporate income tax in the 1930s. The basic theory was ratified by the Courts in Butler Brothers v. McColgan (1941) and Edison California Stores v. McColgan (1947). It should be noted, though, that the unitary method has never been addressed or directly authorized by legislation. Who's in and who's out has largely been a long struggle in policy between the Franchise Tax Board and taxpayers through the courts.

For multi-state and multinational corporations, which by definition conduct business and earn profits in more than one taxing jurisdiction, the U.S. Constitution limits the states' ability to tax their operations to that portion of a corporation's total net income that is derived from or attributable to sources within that state. In 1966, California adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) that included a three-factor formula (property, sales and payroll) for apportioning
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income to California for multi-state corporations. There are no provisions in this act relating to unitary combinations.

Although multi-national corporate affiliations existed well before the turn of the century, it wasn’t until sometime in the early 1970s that the Franchise Tax Board staff began for the first time to require foreign affiliates to be combined as part of the unitary group. This method, known as "worldwide combination," became the subject of much international attention because of its implications for taxing foreign earned income. Although legal challenges to the methodology failed at the U.S. Supreme Court (See Container Corp. of America v. FTB (1983) and Barclays Bank PLC v. FTB (1994)), legislative efforts for reform began in the late 1970s.

From the tax agency's point of view, worldwide combination represents the "purity" of taxing multi-tiered, multinational corporations. FTB argues that only by combining all the elements of the multi-tiered business then apportioning that combined income to California based on the apportionment formula can California tax its fair share. Otherwise, it argues, the currency rates and transfer pricing rules allow for the manipulation and hiding of income outside California's reach.

The objection to worldwide combination from many of our trading partners, in particular the British and Japanese, was significant. It's not often that the tax policies of a state are the subject of debate, much less legislation, in British Parliament. Worldwide combination caused that, and more. In 1985, the U.K. approved legislation that would have allowed the U.K. Treasury to penalize multinational groups of companies with operation in any U.S. state that employed the worldwide unitary method.

While the unitary method has its merits for measuring domestic group income, the method has severe consequences when applied on a global basis. Other countries have different accounting rules and standards and significantly different taxing regimes. We are accustomed here in the states to having uniform rules of accounting and taxation, generally speaking. That is not the case internationally.

What's more, no nation, not even the United States, has adopted a unitary apportionment methodology for the purpose of taxing international businesses. International tax and the numerous bilateral double-taxation treaties to which the United States is a party are predicated largely on the arm's length / separate accounting methodology, where tax is imposed on foreign-owned companies only on the profits arising in the country or state in which they operate. Thus, from a foreign competitor's point of view, when a California company goes abroad, it is not subjected to the type of tax reach that California was seen has trying to place on foreign companies coming to California. This duplicity was the foundation for what could have resulted in an international tax war had California not done something to limit the scope of worldwide combined reporting.

The unitary worldwide combination methodology produces a number of significant consequences for multinationals:

1) A multinational would have to provide accounts to each taxing authority in whose jurisdiction it operates, according to those standards, accounting rules and
the tax regime imposed there, then recalculate its worldwide earnings according to the unitary method of California.

2) When California uses the worldwide method and another foreign entity uses the separate accounting method, a multinational could end up paying tax on more than 100 percent of its income because of the differing rules for allocation of income.

3) The unitary system actually discourages investment in California, because investments in property or payroll will increase the share of the corporation's foreign income subject to tax in California (because of the apportionment formula). That's bad for jobs. Marginal investments (start-ups) become incredibly expensive to pursue here as a result, and foreign investment is made almost prohibitively expensive. What's more, the perceived attack that worldwide combination presents to foreign investment and foreign companies also was likely to produce retaliatory action by many of our trading partners around the world.

California's effort for resolving the unitary tax mess passed its first hurdle with the adoption of SB 85 (Alquist) in 1986 (passed by 27 to 7 in the Senate and 65 to 11 in the Assembly). The legislation abolished the mandatory worldwide combination methodology. SB 85 allowed corporations to elect between worldwide combination and the "water's edge." Under this "water's edge" election, the unitary or combined group is comprised only of those affiliated corporations within the "water's edge" of the United States (the 50 states and the District of Columbia). Still, the international rancor didn't diminish until the 1993 passage of SB 671 (Alquist), which cleaned up the many flaws contained in SB 85, including a fee schedule and an incredibly long election period.

When originally adopted, the water's edge election was actually a contract entered into between the taxpayer and the Franchise Tax Board for a period of ten years that contractually bound both the taxpayer and the FTB to the water's edge election. Thus, every year, the taxpayers who elected water's edge committed themselves to another term of 10 years. The period subsequently was changed to 7 years. The "contract" method then was changed to a straight annual method; however, repeal of the water's edge could only be possible beginning 7 years from the date of the original election-otherwise, the state would be breaching each contract with those companies that elected in prior years to be treated under the water's edge provisions.

The water's edge election, and the number of changes that have been made since SB 85's original passage, by most accounts even among tax administrators is that it has been a success in ensuring both that California is allowed to tax profits really derived from or attributable to California, and that California business taxpayers with operations here and abroad are not so overburdened with reporting nor penalized for their investments here, so there is less impediment to job growth here. Our trading partners are relatively happy because their constituents are not being unreasonably burdened or taxed by a sub-state, thus easing the tensions of a tax war.

The following is an excerpt from The Sacramento Bee on the passage of the water's edge election bill, SB 85:
"Plainly, the resulting tax proposal owes more to heavy bartering than to any purist pursuit of the best way to compute corporate taxes ... Yet something had to be done about California's unitary taxing method – not because it is unfair or inefficient, but because the nation's most important trade partners object to it violently. Its mere existence provokes foreign policy problems for the nation (which Congress and the president are itching to resolve if California doesn't) and hinders foreign investments in the state. Unitary taxing simply isn't worth all that. Under the circumstances, Californians probably should feel lucky that the package finally worked out by the negotiators is as sane as it is." (Sacramento Bee Editorial, August 22, 1986.)

It is hard to convey the level of global animosity projected toward California by some of our most important trading partners resulting from the application of worldwide combination. Our trading partners view worldwide combination as taxation beyond our borders, and no doubt would retaliate against us should we reverse course and erode the water's edge election.

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