



## Bill Analysis

Author: Connolly, et al.

Sponsor:

Bill Number: AB 1790

Related Bills: See Legislative  
History

Introduced: February 10, 2026

### SUBJECT

Elimination of Water's-Edge; Conformity to Net Controlled Foreign Corporation (CFC) Tested Income (NCTI)

### SUMMARY

This bill, for taxable years beginning on or after January 1, 2026, would require a taxpayer that files on a water's-edge basis to include all income and apportionment factors of any corporation, other than a bank, whose United States (US) sales factor is equal to or greater than 20% (rather than an average of its US property, US payroll, and US sales factors), 40% of any NCTI, and would make other non-substantive changes.

The bill would also terminate all existing water's-edge elections effective for the first taxable year beginning on or after January 1, 2028, and would not allow a taxpayer to make a water's-edge election, or file on a water's-edge basis, for taxable years beginning on or after January 1, 2028. The bill would also allow any water's-edge taxpayer to terminate their election without the consent of the Franchise Tax Board (FTB) for taxable years beginning on or after January 1, 2026, and before January 1, 2028.

### RECOMMENDATION

No position—The three-member Franchise Tax Board has not formally voted or taken a position on this bill.

### SUMMARY OF AMENDMENTS

Not applicable.

### REASON FOR THE BILL

The reason for the bill is to eliminate the water's-edge filing method.

**ANALYSIS**

This bill would, for taxable years beginning on or after January 1, 2026, amend the water's-edge provisions to require, the inclusion of the entire amount of income and apportionment factors from:

- Any corporation, other than a bank, regardless of the place of its incorporation, if its US sales factor is equal to or greater than 20%, rather than using the average of their US property, US payroll, and US sales factors.
- Any corporation that is a member of a water's-edge group that is incorporated in the US or formed under the laws of any state, the District of Columbia, or any territory or possession of the US.

The bill would require a corporation, not otherwise required to include its entire income and apportionment factors, in the water's-edge combined report, for taxable years beginning on or after January 1, 2026, to include 40% of any NCTI as business income. The term "Net CFC Tested Income" would mean the term as defined in the Internal Revenue Code (IRC) section 951A. In addition, no factors of any CFC, as defined in IRC section 957, would be included in the combined report as a result of the inclusion of the NCTI as business income.

For taxable years beginning on or after January 1, 2028, this bill would not allow taxpayers to make a water's-edge election or file a return on a water's-edge basis. This bill would also allow a taxpayer to terminate their water's-edge election without the consent of the FTB for any taxable year beginning on or after January 1, 2026, and before January 1, 2028. Lastly, the bill would terminate every water's-edge election as of the first taxable year beginning on or after January 1, 2028.

*Effective/Operative Date*

As a tax levy, this bill would be effective immediately upon enactment. The amendments would be operative as follows:

- The provisions relating to the use of the 20% or more US sales factor, rather than the average of their US property, US payroll, and US sales factors would be operative for taxable years beginning on or after January 1, 2026;
- The provisions relating to the inclusion of 40% of any NCTI as business income would be operative for taxable years beginning on or after January 1, 2026;
- The provisions related to the taxpayer's ability to terminate its water's-edge election without the FTB's consent would be operative for taxable years beginning on or after January 1, 2026, and before January 1, 2028;
- The provisions prohibiting a taxpayer from making an election or filing on a water's-edge basis would be operative for taxable years beginning on or after January 1, 2028; and
- The provisions terminating every water's edge election would be operative as of the first taxable year beginning on or after January 1, 2028.

*Federal/State Law**Federal Law*

Under current federal law, corporations organized in the US are taxed on all their income, regardless of source, at the flat rate of 21%. In addition, any US shareholder of a CFC for any taxable year, includes in gross income their share of NCTI, which is a US shareholder's excess (if any) of their aggregate pro rata share of CFC tested income for the taxable year, over the US shareholder's CFC tested loss for the taxable year. US organized corporations are allowed at their option either a credit or a deduction for taxes paid to a foreign country on income earned from a foreign source.

Foreign corporations that are engaged in US trade or business are taxed at the 21% regular US rate on the net income effectively connected with the conduct of that trade or business in the US (unless a lower tax rate or different treatment applies by application of a US-foreign tax treaty). If the income is treated as a fixed and determinable annual or period rate, then a withholding rate of 30% (or a lower rate if provided by US-foreign tax treaty) is applied on the total income.

*State Law*

Under California law, corporations deriving income from sources both within and outside California are required to measure their tax liability by reference to their income derived from or attributable to sources within California. To determine the portion of total income that is attributable to California, the apportionment method of business income and allocation method of nonbusiness income are used.

In addition, all affiliated US and foreign entities, comprising a single trade or business, are viewed for California income tax purposes as a whole called a "unitary group." The business income of all the affiliates that comprise a unitary group is apportioned and reported to California on a single report known as the "combined report." This "combined report" also includes any nonbusiness income from the unitary group members that is allocated to California.

The apportionment method uses a formula to calculate the amount of a unitary group's total income that was generated from the unitary group's activities in California. This formula is comprised of a single sales factor that measures the activity of a unitary group in the state.

Conversely, a qualified business that derives more than 50% of its gross business receipts from conducting one or more qualified business activities, including agriculture or extraction must use the apportionment formula for qualified business activities, which is comprised of three components that measure the activity of the unitary group in the state: property, payroll, and sales – all divided by three.

The unitary group's California business income is then apportioned among the members that are taxable in California. Allocation rules source nonbusiness income to a state, depending on the type of income. Any nonbusiness income that is allocated to California is then added to that entity's taxable income. Each member retains a separate tax identity and liability.

California law requires a unitary group to file on a worldwide combined reporting basis or to elect the option of calculating its California income and activities on a water's-edge basis. A water's-edge election requires that the taxpayer file on a water's-edge basis for at least 84 months. Generally, water's-edge taxpayers can exclude foreign-organized unitary affiliates that would otherwise be part of the unitary combined report. However, in addition, the water's-edge rules require that the income and apportionment factors of certain foreign-organized unitary affiliates be included, fully or partially, in the apportionable income and apportionment factors of the water's-edge group. Lastly, any foreign income that is effectively connected to a US trade or business, along with the related apportionment information, must also be included in the water's-edge combined report.

The water's-edge group is allowed a 75% dividend received deduction for their qualifying dividends received from its foreign affiliates. This deduction is known as the "foreign dividend deduction." A 100% deduction is provided for dividends from certain foreign construction projects.

### *Implementation Considerations*

FTB has identified the following considerations and is available to work with the author's office to resolve these and other considerations that may be identified.

In Section 25106.5(c), this bill discusses several provisions relating to the combined reporting method as legislative findings and declarations. For clarity as to which provisions would be statutory requirements, the author may wish to move the desired mandatory requirements into the relevant statute section or limit the findings or declarations.

Revenue and Taxation Code (RTC) section 25110(a)(2)(A)(ii) provides that the income and apportionment factors of certain CFCs are included in the water's-edge combined report. In Section 3 of the bill, RTC section 25110(a)(2)(A)(iii) would require the inclusion of 40% of any NCTI. In addition, clause (iii) states that no factors of any CFC would be included in the combined report as a result of including that income, which may contradict clause (ii). For clarity, if the author's intent is to exclude factors of only those CFCs that have NCTI, the author may wish to amend the bill.

#### *Technical Considerations*

For consistency and clarity, consider amending Section 25110(a)(1)(C) by replacing the phrase, "...United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code." with "...United States, or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States." and remove subparagraph (E).

For consistency of terminology, in Section 25110(a)(2)(A)(iii) replace the sentence "Forty percent of net CFC tested income, as that term is defined in Section 951A of the Internal Revenue Code, is included as business income. No factors of any controlled foreign corporation, as defined in Section 957 of the Internal Revenue Code, shall be included as a result of including that income" with "Forty percent of net CFC tested income, as that term is defined in Section 951A of the Internal Revenue Code, relating to Net CFC tested income included gross income the United State shareholders, is included as business income. No factors of any controlled foreign corporation, as defined in Section 957 of the Internal Revenue Code, relating to controlled foreign corporations, shall be included as a result of including that income".

#### *Policy Considerations*

None noted.

#### **LEGISLATIVE HISTORY**

AB 71 (Rivas, et. al 2021/2022) would have, under the CTL, require a water's-edge taxpayer to take into account 50% of global intangible low-taxed income, 40% of repatriation income of its affiliated corporations, and would limit the total use of certain credits, as defined, from reducing the additional tax liability added by the provisions of this bill by not more than \$5,000,000. AB 71 did not pass out of the Assembly by the required deadline.

AB 3372 (Assembly Committee on Revenue and Taxation, Chapter 297, Statutes of 2020), under the CTL, amended the water's-edge election provisions to maintain an otherwise-valid water's-edge election if a unitary foreign affiliate becomes a taxpayer solely due to California's "doing business" statute.

SB 567 (Lara, 2017/2018), under the CTL, would have for taxable years beginning on or after January 1, 2017, eliminate a taxpayer's ability to make a new water's edge election, and for taxable years beginning on or after January 1, 2023, would terminate all existing water's edge elections. However, the May 3, 2017, amendments removed the provision of the bill that would have sunset the water's-edge election. SB 567 did not pass out of the Senate by the required deadline.

## **PROGRAM BACKGROUND**

In general California applies the worldwide combined reporting method to determine the income of a unitary business group that is subject to the California income and franchise tax. However, corporations are allowed to make a water's-edge election by filing Form 100-WE, Water's-Edge Election, with a timely original return Form 100W, California Corporation Franchise or Income Tax Return – Water's Edge Filers. The commencement date of a water's-edge election is the first date of the period for which the election is made and continues to file under the water's edge election for the following 84-months election period.

The water's-edge election allows taxpayers to limit the corporations included in their California combined report to the "water's-edge group." There are various requirements to determine whether or not a corporation is to be included in the water's-edge combined report. Generally, domestic corporations are included, and foreign corporations are included to the extent their US apportionment factor (property, payroll, sales average) is 20% or more. The water's-edge rules do not supersede the unitary concept or California's apportionment and allocation rules.

Once a taxpayer determines which corporations are unitary, those corporations specifically included in the water's-edge provisions are included in the water's-edge combined report. Business income, nonbusiness income, and the apportionment factors are determined using the same rules as those used for worldwide combined reporting. Generally, the only effect of the water's-edge election is the limitation of the number of corporations (their income and apportionment factors) included in the water's-edge combined report.

## **OTHER STATES' INFORMATION**

None noted.

## **FISCAL IMPACT**

FTB's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be determined.

## **ECONOMIC IMPACT**

### *Revenue Estimate*

Due to the many complexities and differences between worldwide and water's-edge combined group reporting, estimating the revenue impact from the provisions of this bill is difficult to measure with certainty. However, it is estimated that for taxable years 2026 and 2027, the provisions requiring the water's-edge filers to include 40% of any NCTI as business income could bring revenue gains up to \$1 billion. In addition, the revision to the foreign affiliated corporation 20% inclusion test, specifically, shifting to the US single sales factor apportionment, could generate up to \$350 million in additional revenue. It is estimated that the revenue gains from moving to worldwide from water's-edge filing could be in the range of \$700 million to \$2.8 billion. Due to limitations in data, these estimates do not account for additional credits and net operating losses (NOLs) that may be used to offset additional tax liabilities.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

### *Revenue Discussion*

During taxable years 2026 and 2027, taxpayers that choose to continue to file on a water's-edge basis could be subject to 40% of NCTI inclusion and modification to the 20% test for inclusion using the US single sales factor for foreign affiliates. Alternatively, during this time period taxpayers may also terminate their water's-edge election early without the consent of FTB.

Current law states that unitary foreign affiliated corporations must be included in the water's-edge combined report if the average apportionment factor, calculated using the average of their US property, US payroll and US sales, is at least 20%. That means the determination of inclusion currently equally weights the average of these three factors. The proposed law would shift this determination to the US single sales factor. This change would alter which foreign corporations are required to be included in the water's-edge combined report. Some taxpayers that were previously included due to a more heavily weighted US physical presence relative to total US sales may no longer be included under the changes of this provision. In the reverse, foreign affiliated corporations with little US presence but significant US sales may now be included when they were not previously. To measure the impact of the modified 20% test of inclusion, the sales data of all corporations in the taxpayer's unitary group would need to be known. Taxpayers that file on a water's-edge basis do not report any details of property, payroll or sales of foreign affiliated corporations that are not included in the water's-edge group. Therefore, we cannot predict additional entities that would now be included in the water's-edge group that were not previously. It is estimated, however, that should this provision increase the water's-edge liability by 5%, there could be a revenue gain of up to \$350 million annually for taxable years 2026

and 2027. Due to data limitations, the above estimate does not account for the fact that taxpayers may have additional stocks of credits and NOLs that can be used to offset the increased tax liabilities.

Federal NCTI provisions require US shareholders who own 10% of a CFC to include their share of the corporation's profits regardless of whether those profits are actually distributed. This is an annual deemed income inclusion. The bill's provisions would require water's-edge filing taxpayers to include 40% of NCTI in addition to their current water's-edge taxable income. Using federal NCTI data for California apportioning water's-edge corporations, it is estimated that the 40% inclusion could result in a revenue gain up to \$1 billion annually for taxable years 2026 and 2027. To note, some taxpayers may have additional stocks of credits and NOLs that can be used to offset these increased tax liabilities.

During taxable years 2026 and 2027, this bill also allows current water's-edge electing taxpayers to terminate their election early without the consent of FTB. While it is generally assumed that most taxpayers file on the water's-edge basis because it is more tax advantageous, due to the complex nature of water's-edge reporting, there could be water's-edge taxpayers that would now benefit from filing on a worldwide basis but have been unable to do so as a result of the 7-year election. It is expected that these taxpayers will revoke their election early, potentially generating an offsetting revenue loss. In addition, the impacts from the inclusion of the 40% NCTI combined with the shift to the 20% test for foreign affiliate inclusion may outweigh the benefits taxpayers receive from the water's-edge election and choose to shift to worldwide filing prior to the prohibition in taxable year 2028.

Due to the many complexities and differences between worldwide and the water's-edge combined reporting group, estimating the revenue impact from the shift to worldwide from the water's-edge filing is difficult to calculate with certainty.

The calculation of tax for taxpayers filing on the water's-edge basis requires the reporting of California sales, US sales, and US profits. For those using the worldwide method of filing, the calculation requires the reporting of California sales, worldwide sales, and worldwide profits. Filing on a water's-edge basis does not require taxpayers to report their worldwide sales or profits on the tax return, providing limited relevant data to directly calculate the revenue impact of them switching to worldwide filing.

Moreover, there are additional considerations which could have significant impacts on revenue from the switch to worldwide from water's-edge combined group reporting. Apportionment factors may decrease as a result of including additional worldwide sales in the denominator. As mentioned, due to data limitations with regard to unreported foreign affiliates, we are unable to reliably estimate changes to income, apportionment and inclusion factors. Next, there is the elimination of the foreign dividends received deduction previously allowed as well as intercompany eliminations.

Furthermore, taxpayers may have stocks of credits and NOLs that were previously excluded or otherwise unable to be used that could offset additional tax liabilities. Finally, the uncertainty of a taxpayer's corporate structure. Taxpayers have the ability to reorganize and restructure their business at any point. These restructurings are nearly impossible to predict or track and could have significant impact on tax liabilities. Taken together, the numerous uncertainties and limited data make it difficult to estimate the impact of these changes.

Although there are no data sources that can provide an exact revenue impact from the shift from the water's-edge to worldwide filing, economic literature in conjunction with limited available data analysis indicates that the revenue gains could range anywhere from 10% to 40% of total water's-edge electing taxpayer liability, or roughly \$700 million to \$2.8 billion annually. The uncertainty of the estimate reflects the combination of the factors discussed above that have potential to significantly change or reduce final tax liabilities, despite likely increases in reported income for most current water's edge taxpayers.

**LEGAL IMPACT**

None noted.

**EQUITY IMPACT**

None noted.

**APPOINTMENTS**

None noted.

**SUPPORT/OPPOSITION**

To be determined.

**ARGUMENTS**

To be determined.

**LEGISLATIVE CONTACT**

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