



STATE OF CALIFORNIA
Franchise Tax Board

How Foreign Subsidiaries are Taxed in California

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Background

When a corporation derives income from sources both in and outside of California, a portion of the that income may be taxed by California.

If a corporation consists of multiple entities that engage in a unitary business, it completes a “combined report” to compute its California tax liability.

LLCs and partnerships are included while S corps are not included.

A combined report is not the same as a federal consolidated report, and it is not a tax return or tax form.

The Combined Report

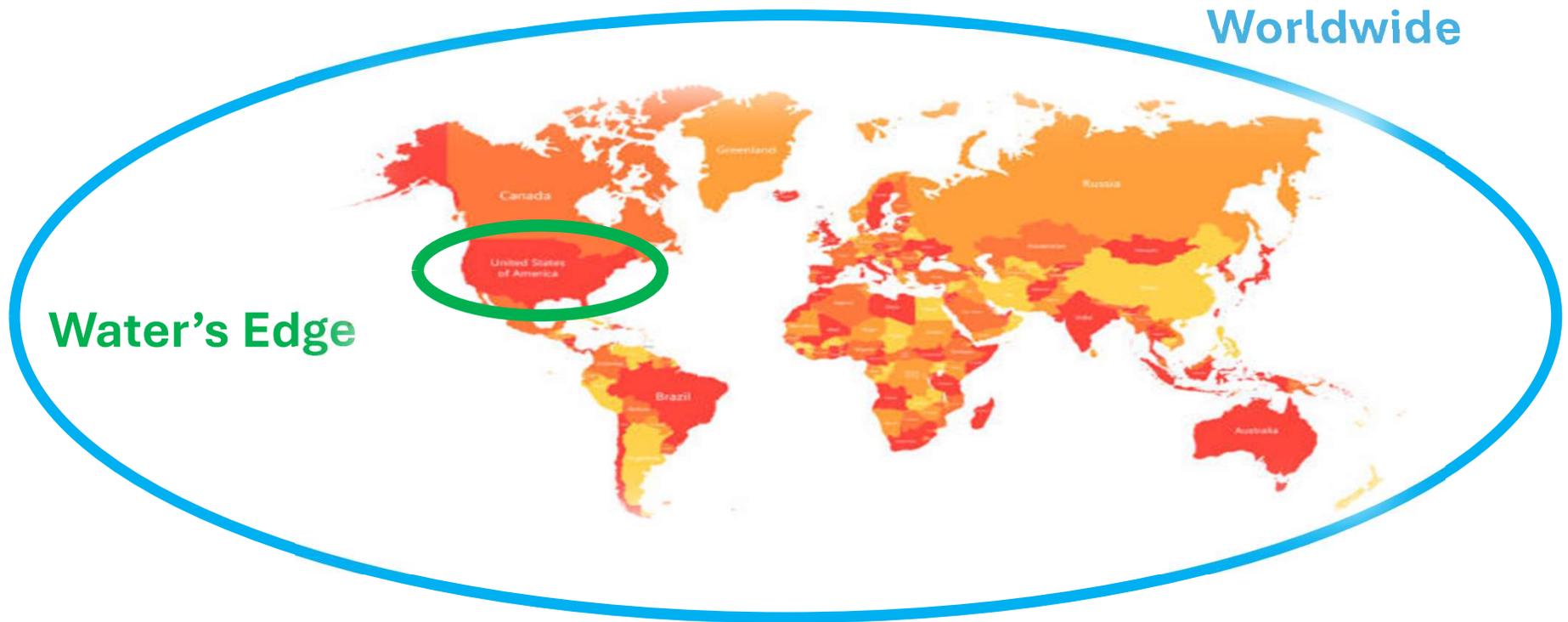
Worldwide Unitary Group Business Income

Water's Edge Unitary Group Business Income

California Apportioned Group Business Income

Individual Entity California Business Income

Two Methods for Reporting Corporate Income



Water's Edge Election

A Water's Edge election is valid if:

1. The Corporation's tax is computed in a manner consistent with the Water's Edge method; and
2. A written notification of election is filed with the return or on a form prescribed by the Franchise Tax Board.

Election must be made by every member of the combined report that is subject to tax.

Water's Edge Election

Election is valid for 7 years (84-month) period.

How to terminate Election:

- After 84-month period, a corporation terminates by using the Worldwide filing method;
- During the 84-month period, a corporation may terminate with the consent of the Franchise Tax Board

Water's Edge versus Worldwide

In theory, the Worldwide and Water's Edge methods should have similar results because the amount of sales made to California is the same regardless of which method is used.

However, in reality, when the income of foreign entities are eliminated from the combined report due to the water's edge election, the total amount of income subject to tax decreases, which in turn results in less tax being assessed.

Water's Edge versus Worldwide

Fact pattern: Foreign entities generate greater sales and income than domestic entities

	DOMESTIC			FOREIGN			
	Entity A	Entity B	Sum Domestic	Entity C	Entity D	Sum Foreign	Sum All Entities
Separate Company Net Income	40,000,000	10,000,000	50,000,000	175,000,000	25,000,000	200,000,000	250,000,000
California Sales	25,000,000	-	25,000,000	-	-	-	25,000,000
Everywhere Sales	150,000,000	50,000,000	200,000,000	525,000,000	100,000,000	625,000,000	825,000,000

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Water's Edge versus Worldwide

	WATER'S EDGE	WORLDWIDE
Total Group Income	\$50 million	\$250 million
Total California Sales	\$25 million	\$25 million
Total Everywhere Sales	\$200 million	\$825 million
Appt Percentage	12.5%	3%
Income appt to California	\$6,250,000	\$7,575,758
California Tax on Appt Income	\$552,500	\$669,697



Tax savings by making water's edge election \$117,197

Water's Edge Statistics

Table 1: Form Filing Counts and Share of Tax Liability

	Form 100W	Form 100
Count	21,562	337,278
Count %	6.0%	94.0%
Total Tax Liability	49%	51%

Water's Edge Statistics

Table 2: Industries electing Water's Edge method

	Count	Share of liability
DURABLE/NONDURABLE GOODS AND WHOLESALE	33%	29%
PROFESSIONAL, SCIENTIFIC, AND TECHNICAL SERVICES	23%	4%
HOLDING COMPANIES	10%	20%
FINANCE, INVESTMENT, AND INSURANCE	6%	23%
REAL ESTATE	6%	3%
ALL OTHER INDUSTRIES	23%	21%
Total	100%	100%

Water's Edge Statistics

Table 3: Percentage of taxpayers switching method of filing

	2017	2018	2019	2020	2021	2022	2023
Form 100W	6.6%	6.0%	6.1%	2.2%	5.6%	5.0%	4.6%
Form 100	-0.2%	-0.7%	1.0%	0.1%	1.1%	0.2%	0.6%