Assembly & Senate Committees on Revenue & Taxation
Joint Informational Hearing

Peering over the Water's Edge: State Taxation of Foreign Subsidiary Income

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Executive Summary[1]

As an academic, I see my role as providing the Legislature with supplemental context in considering how it might reform corporate income taxation in the state. My goal is to acknowledge a wide variety of perspectives and sources in order to enable the best possible decisions for the people of the state.

To start, all public finance and tax policy is comparative. Consider the current situation. OBBBA will impose substantial costs on certain Californians in relation to their medical care. With no state response, then this amounts to a direct tax on those citizens (e.g., loss of health insurance) and an indirect tax on everyone else (e.g., more crowded emergency rooms for everyone). The cost of these implicit taxes must be compared to any explicit tax policy changes.

As to the choice among tax instruments, the analysis is similar. Reforming the CIT is good tax policy on its own but it should be compared to other options. For example, expanding the sales tax could also raise substantial revenue but likely in a more regressive manner.

The water's edge (WE) election is part of California's corporate income tax. It is the largest corporate tax expenditure and among the largest in California's tax system in general. The Department of Finance estimates that it costs California over $4bn/year.[2] The election dates to 1987 and is part of how California addresses nominal versus actual foreign source income.

Eliminating this election would – likely - raise money primarily from the largest, most profitable – and generally most tax aggressive – multinational corporations. Because this change would raise revenue that should already be collected from taxpayers who can afford to pay, this would make California's tax system more efficient and more fair. The primary objection to this reform is administrative, and so one important area I will address is compliance.

Tax Policy Background

The Corporate Income Tax. The corporate income tax is a tax on the profits of corporations. There is a long-running dispute as to who really pays the corporate income tax (e.g., shareholders or workers) and whether the tax overall is a drag on economic activity. The most recent research tends to the conclusion that the tax is borne mostly by shareholders and highly paid workers, which makes the tax relatively progressive.[3] There is also significant recent research that indicates that the tax is relatively efficient. This is because an increasing share of the profits subject to the tax were generated by firms earning supranormal profits. A tax on such profits is efficient because such firms will not reduce their economic activity when that activity is so profitable.[4]

Income Shifting. Income shifting refers to tax planning techniques that move income from the jurisdiction in which it is earned into a lower tax jurisdiction. Here is an example of what this looks like. A big widget company sells 1 million widgets in California. The company's profit margin is $100 per widget and so it should pay tax in California on $100mn in profits. However, the company incorporates a subsidiary in a low-tax jurisdiction, say Ireland, and places its valuable intellectual property in that jurisdiction. The foreign subsidiary charges the US-based company a high licensing rate for use of its intellectual property, say $90 per widget. Because of this new expense, which amounts to one hand paying the other, the US-based Widget corporation reports $10 million in profits in the United States.

The size of the income shifting problem is in dispute, but the weight of authority is that it is a large problem, one that has not been much impacted by national and international efforts to combat the issue. "In 2018-2020, US multinational corporations booked a similar share of their foreign profits in tax havens — around half — as in the years immediately preceding the reform."[5] Indeed, there is convincing evidence that the problem has escalated dramatically since the 1970s, when less than 2 percent of multinational profits found their way to low-tax jurisdictions.[6] This trajectory suggests that income shifting has grown as a problem and could expand further if not combatted. A 2021 Treasury report concluded with notable directness: "Tax havens are as available today as they were prior to the 2017 tax reform."[7]

One prominent estimate is that $300 billion in profits is currently shifted out of the US tax base annually.[8] That is about 20% of the corporate tax base. Note that, given the size of the California tax base, a 20% increase is in line with DOF estimates.

Note that even leading commentators who tend to believe that the income shifting is of absolute smaller size also acknowledge that it is neither fair nor efficient for certain firm to gain an advantage through aggressive tax maneuvers.[9]

Combined Reporting. Notice that in the example, the taxpayer reduced its taxes by essentially paying itself. If the profits of the subsidiary in Ireland were combined with the profits of the US parent, then no income would be lost. Such an approach is

called combined reporting. California was a pioneer in the use of this method[10] and it is the reason why a corporation would not avoid California corporate income tax through shifting income to a subsidiary in Nevada or Texas, states without corporate income taxes.

Worldwide Combined Reporting. The logic of combined reporting requires that a whole business be combined wherever it is located. If not extended to foreign subsidiaries, the income shifting will just occur outside of the US, which is, in fact, what happens. California did require combined reporting on a worldwide basis until 1987. The constitutionality of this approach was upheld by the Supreme Court twice.[11] Note that a significant justification for these holdings was due respect for federalism concerns, a type of concern the current Court is likely to be attuned to.

Water's Edge Election. A water's edge election permits a taxpayer not to combine its US and foreign operations and is thus an invitation for income shifting abroad. Also, as an election it loses money for the state in two ways. First, the corporations that shift income out of the US opt for a water's edge election. Second, the corporations with losses abroad opt to be combined and so pay less in California taxes.[12] California did not permit this election on the basis of a policy analysis. Rather, our trading partners, particularly the UK, pressured the federal government and the federal government in turn threatened to preempt the states. Thus, the water's edge election is a compromise result of bullying from the Reagan Administration.

Other Related Component of California's Treatment of "Foreign Income." California's WE election already addresses "foreign" source income, but these provisions are dated and ad hoc.

An apportioned piece of foreign subsidiary income, measured by the proportion of the CFC's Subpart F income, was and is brought back into the California tax base despite the election.[13] Subpart F income is a type of income identified as likely to shifted in the 1960s – exactly how much to bring in despite the WE election was a matter of negotiation in the 1980s.

As for foreign dividends from subsidiaries, the state now taxes 25% of such dividends. This was also a result of negotiation.[14]

National and International Developments. Because there is a broad consensus that income shifting is a problem, there have been numerous national and international developments. In particular, the federal government has passed two sets of provisions meant to combat income stripping. The first, put in place by the Trump Administration, was called Global Intangible Low-Taxed Income ("GILTI") and now called Net Controlled Foreign Corporation (CFC) Tested Income ("NCTI").[15] The Biden Administration passed the Corporate Alternative Minimum Tax in 2022, which utilizes financial statement income for higher income taxpayers. The international community has proposed – and broadly agreed to – two Pillars of reforms to deal with income stripping (and other issues), Pillar 1 and Pillar 2. Many

countries have moved far along with adopting Pillar 2 in particular. These changes are significant beyond the fact that they show that California would not be out of step in attending to income stripping. Many of the national and international reforms work much like worldwide combined reporting and, in fact, many of them should make worldwide reporting easier.

Compliance Costs. Every tax imposes compliance costs. The right question is whether the burdens are excessive relative to the policy benefits. In this case, common sense and significant evidence suggests the burden will not be too great. Based on evidence collected in the 1980s, courts did not find the burden very large.[16] The notion that current taxpayers, particularly those subject to the CAMT, Pillar 2 and reporting under the securities laws, and only reporting on sales, could not comply at a reasonable cost does not make a lot of sense. Note that California already permits reasonable approximations[17] and has been evaluating WWCR returns for decades.

Water's Edge Election and Competitiveness. There is a claim that worldwide reporting would hurt a state's competitiveness. But this is a bluff. California's corporate tax is not based on the residence of corporations; it is based on where a corporation sells its products. A corporation would not reduce its corporate taxes by moving its facilities out of California; it could only do that by choosing to make fewer profitable sales in California, which does not make a lot of sense. Why wouldn't a sophisticated and profitable corporation not already be charging all it could?

In the end, an argument like this needs to be considered in light of the "compared to what"? question with which I began. Large budget cuts are very likely to be regressive. Other reforms, like reforming the sales tax, would likely be less regressive than the OBBA cuts, but more regressive than CIT reform.

Indeed, there are strong arguments that repealing the water's edge election would make the state *more* competitive for at least two reasons. First, it would eliminate a tax break that gives large, aggressive firms an unfair advantage. Second, the state does give large tax breaks to firms to encourage them to locate in California, particularly the R&D credit. Yet these credits are *against* tax owed, and so they are only valuable if the taxpayer has to pay taxes. Thus restoring the integrity of the corporate tax as to large profitable multinationals could make California's location incentives more effective. Tax credits only work if there is meaningful tax burden to reduce.

Menu of Some Options[18]

- Worldwide combined reporting (WWCR): don't treat income shifted abroad as outside the tax base.
    - Takes advantage of CAMT and Pillar 2.

- Conform to NCTI, which brings back in shifted income by formula.
- Adopt WWCR for large taxpayers, NCTI for smaller.
- In all events adopt other anti-abuse protections.
    - In particular, the state should reform its apportionment rules and cap its R & D credit.

Yes, the state can end the WE. As the Supreme Court has explained, "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."[19] The California legislature can change the prospective terms of an election or eliminate the election. That is not to say that a reasonable transition period might not be appropriate.

I am happy to address any follow-up questions or concerns.

Thank you for the opportunity to engage on this issue.

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[1] For a slightly longer version of the main discussion re WWCR, see Darien Shanske, *White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting*, 89 State Tax Notes 1181 (2018). See also Law Professors Letter on Worldwide Combined Reporting in Minnesota, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4446650.

[2] CA DOF, https://dof.ca.gov/media/docs/forecasting/revenue-and-taxation/tax-expenditure-reports/2025-26-Tax-Expenditure-Report.pdf. ITEP reports a similar number: https://itep.org/worldwide-combined-reporting-state-corporate-taxes/.

[3] William G. Gale and Samuel Thorpe, *Rethinking the Corporate Income Tax: The Role of Rent Sharing*, Tax Policy Center (2022).

[4] Bankman, Joseph and Kane, Mitchell and Sykes, Alan, *Collecting the Rent: The Global Battle to Capture MNE Profits*, Tax Law Review.

[5] See Garcia-Bernardo et al., infra, at 18.

[6] Ludvig S. Wier and Gabriel Zucman, "Global Profit Shifting, 1975-2019," Working Paper 30672 (Nov. 2022).

[7] U.S. Department of the Treasury, "The Made in America Tax Plan" at 9 (Apr. 2021).

[8] Wendy Edelberg et al., *Six Economic Facts on International Corporate Taxation*, Hamilton Project/The Tax Law Center, at 4 (Fact #2: "US multinationals still shift profits into lower-tax countries."). See also: International Monetary Fund, International Corporate Tax Reform, Policy Paper No. 2023/001, at 13 (Feb. 2023) ("According to staff simulations, 18.5 percent of global profit of MNEs is taxed below 15 percent ($1.47 trillion in 2019)"); Javier Garcia-Bernardo, Petr Janský, and Gabriel Zucman, "Did the Tax Cuts and Jobs Act Reduce Profit Shifting by US Multinational Companies?" (May 20, 2022).

[9] See Scott Dyreng, "Are Big Companies Really Moving $100 Billion to Tax Havens?" Duke University, Mar. 19, 2025.
[10] https://www.cbpp.org/research/state-budget-and-tax/states-can-fight-corporate-tax-avoidance-by-requiring-worldwide-0
[11] Barclay's Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994); Container Corp. v. FTB, 463 U.S. 159 (1983).
[12] Accordingly, sophisticated tax advisers advise sophisticated taxpayers to analyze whether WWCR would save them money: See Daniel Sieburg et al., "Worldwide Combined Reporting: An Underutilized Opportunity," The Tax Adviser (Sept. 1, 2019).
[13] Now, formally, what is brought back in is the income of a CFC in proportion to its Subpart F income, but in the usual case Subpart F income is less than the total income of the CFC and so the more Subpart F income of the CFC, the more income of the CFC is included. RTC 25110(a)(2)(A)(ii).
[14] As the legislative history of SB 85 (the statute that first gave us the water's edge election and RTC 24411) indicates, California opted to put in place a watered down version of Option 2. FTB, Bill Analysis SB 85, Jan. 24, 1985 at 5. Option 2 would have included all foreign dividends in the state tax base (subject to apportionment). Option 2 was a particularly protective option advanced by the states. Worldwide Unitary Taxation Working Group (pp. 39-40).
[15] I discuss some issues relating to NCTI here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5703963
[16] "The California Court of Appeal additionally found that Barclays' actual compliance costs were 'relatively modest' during the years just prior to those here at issue, ranging from $900 to $1,250 per annum, for BBI." Barclays, 512 U.S. 298, 314, n.13 (citing 10 Cal. App. 4th, at 1760, n.9)."
[17] See Cal. Code Regs. tit. 18, section 25106.5-10(e)(1).
[18] I have posted some models here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5167213 (WWCR); https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5201312 (NCTI and SSF and R&D).
[19] United States v. Carlton, 512 U.S. 26 (1994). See also further analysis here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3802629.