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This background paper prepares the members of the Senate and Assembly Committees on Revenue and Taxation for the February 11, 2026, joint informational hearing: “Peering Over the Water’s Edge: State Taxation of Foreign Subsidiary Income.”

This paper:

- Describes the framework for income taxation of businesses in California, including multistate and multinational firms.
- Discusses three key tools states use to measure a multistate corporation’s net income: unitary theory, combined reporting, and apportionment.
- Details California’s past and present method for taxing the income of a corporation’s foreign subsidiaries.
- Identifies arguments for and against modifying the present method for taxing multinational corporations.
- Lists options for potential change.

Key questions:

- Given the considerable changes to the economy since the Legislature enacted the water’s edge election in 1986, does California adequately tax the income of a corporation’s foreign subsidiaries and affiliates?
- What are the tradeoffs for and against altering the current method?
- Will changes to the state’s method tangibly reduce global profit shifting? Will such benefits be outweighed by increased compliance burdens? Is the project of minimizing profit shifting better left to the federal government?
- If California revises its method, will there be impacts on the ability of California firms to compete in the global economy?

- Given recent forecasts for structural budget deficits, is altering the taxation of foreign subsidiary income a viable source of additional revenue that outweighs potential tradeoffs?

How to tax a business

Congress enacted the first corporate income tax in 1909. States quickly followed, with California adopting its own in 1929 to replace its franchise tax. Today, all but five states and the District of Columbia have some form of corporate income tax.

Businesses can be organized in many different forms by filing specified documents with the Secretary of State. Once formed, for-profit businesses incur state income tax obligations. How a state taxes a business depends largely on the entity's form. Specifically:

- Businesses formed as C-corporations are generally taxed on their net income or profit at the entity level. A corporation's owners or shareholders also incur a tax liability on their personal income tax returns when the corporation pays a dividend, or when they generate a capital gain from the sale of stock.
- Other business types are taxed as pass-through entities, where income tax is usually not applied at the entity level, but rather the income of the business is "passed through" to owners who report the income from the business on their personal income tax returns and pay appropriate tax. Pass-through entities include S-corporations, Limited Liability Companies (LLCs), partnerships, and disregarded-entity pass-throughs (single-owner entities) such as sole proprietorships, single-member LLCs, and qualified Subchapter S subsidiaries. However, in some cases, these entities may elect to be taxed as corporations, in which case the business would no longer be considered a pass-through entity.

Taxation of multistate and multinational businesses

Calculating a corporation's taxes can be relatively simple for firms doing business solely in one state: multiply the applicable tax rate by the corporation's annual net income. However, multistate and multinational corporations are more complicated. For example, a company can manufacture a product in one state, warehouse it in another, and sell it in a third state. All three states can tax the corporation's net income, but how much?

Constitutional limitations

When taxing the income of multistate or multinational corporations, states must adhere to limits set by federal courts, which have long policed state taxation under both the Due Process and the Commerce Clauses of the United States Constitution. When imposing an income-based tax, "as a general principle, a State may not tax value earned outside its

borders."[1] However, determining value can be easier said than done. Courts have generally upheld state corporate income taxes on businesses where (1) the business has sufficient nexus, or connection, with the taxing state, (2) the tax imposed does not discriminate against interstate commerce, and (3) the tax is fairly apportioned or divided.[2]

Three main tools

In the century or so since states began imposing taxes on businesses operating in multiple jurisdictions, states have developed tools to measure taxes in a way that balances revenue needs with a fair reflection of a business's activity in a state. The three main tools are unitary taxation, combined reporting, and apportionment.

<u>Unitary taxation</u>

Few large businesses consist of just one entity; instead, they are a collection of subsidiaries and affiliates. Like other states, California applies the unitary business principle, borrowed from the property tax and upheld by the United States Supreme Court nearly 150 years ago, to establish which parts of a business are taxable as a whole.[3] The Court recognized that an assessor could not determine the value of a railroad by looking solely at the mileage of railroad track in one county. Instead, accurately measuring the value of any one part of the railway required determining the value of the whole railway.

Applying the unitary theory from property taxes to state corporation taxes was well-summarized by Martin Helmke, Chief Consultant of the Senate Committee on Revenue & Taxation from 1984-2006, using a local deli as an example:[4]

> *Pennisi's Cafe opened for business a couple of years ago to rave reviews … Pennisi's, which in real life is probably a proprietorship or partnership, is a fine example of the fact that you don't even have to be a corporation to be a unitary business. It's the interrelationship among the parts of the business that give it unitary character. It acts as a unit, with common objectives and interests. What it all boils down to of course is that the business unit, all the parts working together under common ownership, control and guidance, is substantially more profitable and stable than the individual parts would be if operated as separate enterprises.*

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[1] *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 315 (1982).
[2] *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).
[3] *Union Pacific Railway Co. v. Cheyenne*, 113 U.S. 516 (1885).
[4] "Notes on Unitary Reform and California's Response to Federal Tax Reform" for the California Council for International Trade International Tax Committee Meeting. December 11, 1986.

> *The key to the debate over taxation of unitary business is the question of how to split such a business apart, for tax purposes, and determine how much of the total profits are truly attributable to one geographical segment of the business. In my Pennisi's example, how much of the total profit is due to the efforts of the cafe and how much to the delicatessen? How much to the activities and management expertise of the parent corporation? And how much to the fact that the segments of the business can lean on each other during the down portions of their respective cycles, giving the combined group a much greater likelihood of long-term survival and growth?*

As a starting point, California measures a corporation's tax by its income derived from, or attributable to, sources in California. However, no statutory criteria for determining whether any given subsidiary or affiliate is in a unitary business with its parent corporation exist. Instead, a body of court and administrative decisions have, over time, provided evolving guidance. For the most part, a subsidiary or affiliate is considered part of a unitary business group when there is *unity of ownership*; *unity of operation* (via central purchasing, advertising, accounting, and management); and *unity of use* in its centralized executive force and general operations.

California Code of Regulations, Title 18, Section 25120(b), provides authoritative rules and examples. While always dependent on an individual taxpayer's facts and circumstances, the regulations presume "activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon, or contribute to each other and the operations of the taxpayer as a whole."

Combined reports

Two or more corporations conducting a unitary business within and outside of California must use the combined reporting approach to determine California source income. As noted by the Franchise Tax Board's (FTB) combined reporting guidelines:[5]

> *The combined report is a means by which the income of a unitary business is divided among the taxing jurisdictions in which the trade or business is conducted. A combined report is not a "return," but merely the name given to the calculations by which multi-entity unitary businesses apportion income on a geographic basis.*

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[5] Franchise Tax Board. "2022 Guidelines for Corporations Filing a Combined Report." FTB Publication 1061. https://www.ftb.ca.gov/forms/2022/2022-1061-publication.pdf

A significant advantage of combined reporting is the ability to cancel intracompany transactions. Combined reporting makes it more difficult for taxpayers to inflate expenses in a high-tax state while shifting profit to a low or no-tax state. Without combined reporting, calculating income defaults to transfer pricing, the price at which related subsidiaries buy and sell goods, services, and intangibles within a corporation. Intellectual property such as patents, trademarks, or search engine algorithms often do not have clear values, creating more opportunities for profit shifting through transfer pricing. By discarding transactions within a unitary group, combined reporting allows a more accurate measure of the net income of the unitary business.

California was first among states in adopting combined reporting in the 1930s: [6]

> *California was one of the first to uncover such manipulation. It discovered Hollywood studios selling or licensing movies at artificially low prices to subsidiaries they had established in low- or no-tax states, which then distributed the film reels to movie theaters throughout the country. Little profit showed up on the books of the California studios; most of it showed up on the books of the distribution affiliates. An attorney for the California tax agency determined that the most straightforward way to shut down this manipulation was to require the movie studios to combine their profits with those of the distribution subsidiaries before doing the apportionment calculation, and "combined reporting" was born. Combined reporting was initially applied on an ad hoc basis in instances when a corporate income tax auditor concluded that abusive tax avoidance was occurring, but by the mid-1960s it was standard California practice.*

Apportionment

Apportionment is the process by which each subsidiary and affiliate on the combined report divides its income among the states in which it does business. For example, if 10% of a company's nationwide sales are made to California customers in a particular year, 10% of the company's net income in that year will be taxable in California. In California, almost all firms apportion income by using the "single sales factor" formula. The formula requires firms to apportion their income by multiplying their total net income by a percentage equal to its sales in the state divided by its total sales.

[6] Michael Mazerov, Center on Budget and Policy Priorities. "States Can Fight Corporate Tax Avoidance by Requiring Worldwide Combined Reporting." June 27, 2024. https://www.cbpp.org/research/state-budget-and-tax/states-can-fight-corporate-tax-avoidance-by-requiring-worldwide-0.

Taxation of multinational businesses and their foreign subsidiaries

Given the ability of modern multinational corporations to shift valuable intellectual property to foreign jurisdictions, with either low tax rates or no corporate income taxes at all, the unitary principle and combined reporting should apply to their foreign subsidiaries and affiliates. While estimates vary,[7] research indicates multinational corporations have cleverly shifted significant profits to foreign subsidiaries that would have otherwise accrued in the United States and become subject to federal and state taxation.[8] Income shifting takes a variety of forms: [9]

> *Value in our modern economy increasingly derives from intangible assets: patents, trademarks, algorithms, brands, and other intellectual property. [Multinational enterprises], particularly in technology and pharmaceutical sectors, routinely transfer these valuable assets to subsidiaries in low-tax jurisdictions. The U.S. parent company or its operating subsidiaries then pay tax-deductible royalties to the foreign subsidiary for using this intellectual property. Because royalty payments reduce U.S. income while the royalty income accumulates in low-tax jurisdictions, profits effectively shift from high-tax to low-tax jurisdictions without any real economic activity moving. Other common mechanisms include intracompany debt structures that strip profits through deductible interest payments and hybrid entities or instruments that exploit mismatches between tax systems to create deductions without corresponding income inclusion.*

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[7] Scott Dyreng, Robert Hills, and Kevin Markle. "Using Financial Accounting to Estimate the Income Shifting of U.S. Multinationals." November 12, 2023. https://ssrn.com/abstract=4007595; Kimberly A. Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act," National Tax Journal, December 2020. https://www.jstor.org/stable/26947959.; Thomas Tørsløv, Ludvig Wier, and Zucman, "The Missing Profits of Nations," 90(3) Review of Economic Studies1499 (2023). https://www.nber.org/system/files/working_papers/w24701/w24701.pdf. See also Steve Wamhoff, "Ongoing Use of Offshore Tax Havens Demonstrates the Need for the Global Minimum Tax," Institute of Taxation and Economic Policy, Jan. 17, 2024. https://itep.org/offshore-tax-havens-corporate-tax-avoidance-demonstrates-need-for-global-minimum-tax.

[8] Fatih Guvenen, Raymond J. Mataloni, Jr., Dylan G. Rassier, and Kim J. Ru. "Offshore Profit Shifting and Aggregate Measurement: Balance of Payments, Foreign Investment, Productivity, and the Labor Share". NBER Working Paper No. 23324. April 2017, Revised February 2022. https://www.aeaweb.org/articles?id=10.1257/aer.20190285.

[9] Darien Shanske and David Gamage, "Profit Shifting Among the States: A Short Primer." State Tax Notes, Sept. 3, 2025. https://www.taxnotes.com/special-reports/corporate-taxation/profit-shifting-and-states-short-primer/2025/09/02/7sysy.

However, all states with a corporate income tax, including California, generally allow multinational corporations to exclude the income of foreign subsidiaries from their combined groups through a "water's edge election." But this was not always the case.

Before water's edge

While its specific origins are unclear, California is generally acknowledged as the state that led the effort to impose "worldwide combined reporting" on multinational taxpayers in the 1970s.[10] The FTB won twice at the United States Supreme Court when defending the method.[11] By the early '80s, at least 15 states required worldwide combined reporting, 12 of which applied it on a worldwide basis, meaning that a California subsidiary of a foreign corporation must include in its combined group both its foreign parent and any of its other unitary foreign subsidiaries.

Soon after California won *Container Corp.*, then President (and former California Governor) Ronald Reagan convened the Worldwide Unitary Taxation Working Group within the Department of the Treasury. The Group's final report warned that if "there are not sufficient signs of appreciable progress by the states, federal legislation would be sponsored."[12] The strong implication was that Congress would act to preempt states from including income from foreign subsidiaries using its powers under the Commerce Clause unless states discarded worldwide combined reporting. Foreign companies also stated that they would pass over states with worldwide combined reporting when investing in the United States.

Though the Legislature first considered measures to repeal worldwide combined reporting as far back as the 1970s, it was not until 1986 that the Legislature enacted a measure to allow the water's edge election (SB 85, Alquist). The change came after years of strenuous debate and discussion, as well as engagement by multinational businesses and threats of retaliation by foreign governments, notably the United Kingdom and Japan. All other states that previously required worldwide combined reporting soon followed California's lead and discarded the requirement. Today, only Alaska requires worldwide combined reporting, and only for specified oil companies.

The Legislature made subsequent modifications to the election in the years following SB 85. Today, California:

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[10] David Doerr. "California's Tax Machine. A History of Taxing and Spending in the Golden State." California Taxpayers Association (2008), p. 582.

[11] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

[12] U.S. Treasury Department, "The Final Report of the Worldwide Unitary Taxation Working Group." August 1984. https://ia601300.us.archive.org/28/items/finalreportofwor00unit/finalreportofwor00unit.pdf.

- Allows Corporation taxpayers to exclude foreign corporations from the calculation of business income, with some exceptions, including Domestic International Sales Corporations, and corporations with average apportionment factors in the U.S. that exceed 20%. Controlled Foreign Corporations' Subpart F income is also included according to a ratio boutique to California.
- Maintains worldwide combined reporting as the default method; however, Corporations can elect water's edge in a form submitted to FTB, which binds the taxpayer for the next seven taxable years.
- For water's edge filers, allows corporations to deduct (generally up to 75%) dividends paid from foreign affiliates. A key part of the measure, SB 85 included the deduction because foreign dividends are income earned in another country and are usually taxed there, so including them could result in double taxation and a competitive disadvantage for U.S. corporations compared to foreign companies.

For example, imagine a firm with two unitary subsidiaries: one in California and the other in Europe, both with $1 billion in domestic gross sales. The California subsidiary only sells in the United States, and the European one only in Europe. If 10% of sales are in California, California taxes 10% of any profit the California subsidiary derives on its sales under the water's edge method; the European one doesn't count. However, under worldwide combined reporting, California would tax 5% of the profits on $2 billion in gross sales because including the foreign subsidiary's sales halves the sales factor. Differences in tax paid between the two methods depend on whether the American or European entity was more profitable, but the gross sales apportioned to California are the same either way.

Happy 40th birthday to water's edge

California's water's edge election turns 40 years old this year, and except for small modifications in the years that followed its enactment, remains largely unchanged. As a result, the Legislature may wish to reconsider the state's framework for the taxation of foreign subsidiary income, given changes that have occurred in recent years. Among them:

- Large multinational corporations generally have a lower effective tax rate than smaller in-state businesses, granting them a competitive advantage because they can shift profits to foreign subsidiaries.
- The economy has evolved from one centered on manufactured products, to services and intangibles, and now, to the advent and rapid growth of the global digital economy. Shifting income-producing intellectual property to low-tax

jurisdictions is a common strategy among global technology and pharmaceutical firms.[13]

- Aggressive competition between countries to craft favorable tax laws to induce mobile capital investment results in a shift of profits from high-tax to low-tax countries and the creation of "stateless income," income that is so highly mobile and had such little physical presence that it could successfully evade the efforts of any single state to impose tax on that income using traditional tools.
- Congress enacted the Tax Cuts & Jobs Act (TCJA) in 2017, which discarded the previous system of federal taxation where taxes on foreign subsidiary income were deferred until paid to the domestic parent. Instead, TCJA implemented a "territorial system," which only includes a foreign subsidiary's income that is minimally taxed abroad for federal income tax purposes. TCJA also lowered the federal corporate income tax rate from 35% to 21% and significantly reduced the *effective* corporate income tax rate, although overall corporate income tax revenues increased from 2021 to 2023.[14]
- Foreign income of U.S. multinationals has grown significantly. Since 1996, the pre-tax foreign income of U.S. multinational companies has grown from $100 billion to over $550 billion.[15]
- Corporate taxpayers can generally deduct increases in state taxes from federal taxable income.
- While no state has yet required worldwide combined reporting (except Alaska in modified form for some oil companies), Connecticut, the District of Columbia, Hawaii, Maine, Maryland, Minnesota, Nebraska, New Hampshire, Oregon, Tennessee, and Vermont have considered doing so in recent years.
- California's pending fiscal deficit for fiscal year 2026-27, estimated by the Legislative Analyst's Office to be $18 billion, is spurring consideration of changes in state taxes to generate additional revenue.[16] Research indicates that states can generate revenue by enacting worldwide combined reporting.[17]

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[13] Among others, Brad Setser, Council on Foreign Relations. "Tax Games: Big Pharma Versus Big Tech." February 12, 2020. https://www.cfr.org/articles/tax-games-big-pharma-versus-big-tech.
[14] Peter G. Peterson Foundation, "How did TCJA affect Corporate Tax Revenues." May 13, 2024. https://www.pgpf.org/article/how-did-the-tcja-affect-corporate-tax-revenues/
[15] Dyreng, Ibid. Noting that some of this income is subject to tax in the foreign country.
[16] Gabriel Patek. "The 2026-27 Budget California's Fiscal Outlook." Legislative Analyst's Office. November 19, 2025. https://lao.ca.gov/Publications/Report/5091.
[17] Mazerov, Ibid.

Trouble ahead

The Legislature has considered previous proposals to either restore mandatory worldwide combined reporting or include income from foreign subsidiaries excluded from the water's edge group in the past, none of which were enacted: SB 1876 (Alpert, 2004), AB 34 (Ruskin, 2005), AB 441 (Chu, 2005), AB 2829 (Ridley-Thomas, 2006), and SB 567 (Lara, 2017).

Opponents of altering the current system argue:

- Many businesses will incur increased compliance costs, including additional unitary analysis, conforming foreign subsidiaries' accounting records from local rules to align with state requirements, and converting currency to dollars where applicable, among other administrative burdens.[18]
- Worldwide combined reporting intrudes on the federal government's responsibility to regulate foreign commerce uniformly, including its ability to form tax treaties.
- Worldwide combined reporting requires the inclusion of income derived in other countries where the connection to the taxing jurisdiction may not be clear, thus posing constitutional concerns.
- Repealing the water's edge election may result in uncertain or volatile revenue. While additional income must be reported, so too are sales factors, which could dilute apportioned income.
- International efforts are superior to state efforts when addressing profit shifting. The Organization for Economic Cooperation and Development's (OECD's) Base Erosion and Profit Shifting Project intends to limit profit shifting in the global digital economy. On January 5, 2026, the OECD announced an agreement between 147 countries on "key elements of a package that charts a course forward for the coordinated operation of global minimum tax arrangements," with the U.S. joining via a "side-by-side" arrangement. To the extent states include foreign subsidiary income within their tax base, U.S. multinationals would be at a disadvantage compared to foreign corporations in countries that do not tax foreign income.
- The TCJA's requirement that U.S. multinationals include Global Intangible Low-Tax Income (GILTI), which was recently replaced with Net Controlled Foreign Corporation Tested Income (a.k.a. Net CFC Tested Income or "NCTI", sometimes called "necktie") provides relative parity for taxation of foreign subsidiary income.
- Congress also enacted a Corporate Alternative Minimum Tax in the Inflation Reduction Act of 2022, which imposes a minimum tax of 15% for companies earning

[18] Jared Walczak. "Maryland Shouldn't Mandate Worldwide Combined Reporting Through the Back Door." Tax Foundation. March 25, 2025. https://taxfoundation.org/blog/maryland-worldwide-combined-reporting-mandatory.

over $1 billion per year, another federal provision intended to ensure adequate taxation of U.S. multinationals. However, it is unclear whether the Internal Revenue Service is currently enforcing the tax.[19]

Options

Should the Legislature wish to consider options to change the state's current method for including income of foreign subsidiaries within its tax base, options include, among others:

- *Immediate repeal of the Water's Edge Election*. A water's edge election binds a taxpayer for seven subsequent years after the taxpayer makes it, at which time the taxpayer can renew for a subsequent seven years. However, this immediate approach could be challenged as a Due Process Clause violation.
- *Sunset the Water's Edge Election*. Instead of immediately terminating existing elections, California could deny taxpayers the ability to renew elections by sunsetting the current water's edge election. However, any additional revenue would come in more slowly as taxpayers default to worldwide combined as their elections expire.
- *Adopt the tax haven approach*. Researchers have identified substantial profit shifting among U.S. firms in nine well-known tax havens (Bermuda, British Virgin Islands, Cayman Islands, Ireland, Luxembourg, Netherlands, Puerto Rico, Singapore, and Switzerland.)[20] Montana enacted the first tax haven bill in 2003 and was followed by at least six other states, with Colorado being the most recent. States have named specified jurisdictions by creating a "black list" (explicitly naming countries whose tax regimes enable evasion) or a "grey list" of nations (whose tax systems enable tax avoidance according to criteria applied by an administrative agency). Under these measures, corporations must then include income from foreign subsidiaries in those jurisdictions defined as tax havens within the water's edge.
- *Require the inclusion of NCTI*. Corporations must include NCTI as income for federal tax purposes, which is basically income derived from a U.S. multinational's foreign subsidiaries, from its intangible assets, that is either undertaxed or not taxed by its home jurisdiction. States have acted both to require taxpayers to include NCTI as well as to decouple from it.

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[19] Jessie Drucker. "How the Trump Administration is Giving Even More Tax Breaks to the Wealthy." New York Times. November 8, 2025. https://www.nytimes.com/2025/11/08/business/trump-administration-tax-breaks-wealthy.html.

[20] Clausing, Ibid; Javier Garcia-Bernardo, Petr Jansky, and Gabriel Zucman, "Did the Tax Cuts and Jobs Act Reduce Profit Shifting by US Multinational Companies?" unpublished working paper, July 19, 2023. https://www.nber.org/system/files/working_papers/w30086/w30086.pdf.

- *Alter the state's Subpart F regime*. While California conforms to federal Subpart F definitions, it has a unique method for calculating Subpart F income subject to tax.
- *Change the Foreign Dividends Exclusion*. As noted above, corporations can deduct (generally up to 75%) dividends paid to the water's-edge combined reporting group from foreign affiliates.