

estimates do not account for additional credits and Net Operating Losses that may be used to offset additional tax liabilities, resulting in reduced revenue gain.

By increasing Corporation Tax revenue, this bill also likely increases Proposition 98 GF spending by approximately 40% of the revenue gain (the exact amount depends on the operative test of the annual Proposition 98 guarantee).

- 2) Costs of an unknown amount to the FTB to administer modified water's-edge reporting rules for taxable years 2026 and 2027 and the shift to worldwide filing beginning in taxable year 2028, including updating related forms, informational materials, and information technology systems and responding to increased taxpayer inquiries.

The Legislative Analyst's Office recently warned of GF structural deficits of around \$35 billion per year in the 2027-28 fiscal year and ongoing.

COMMENTS:

- 1) **Purpose.** According to the author:

For the last 40 years, California has allowed the biggest corporations to choose a tax scheme that ensures they pay as little in taxes as possible. Even though corporate profits have increased to record levels, and the Federal government has reduced their tax rate to historic lows, these multinational companies still stash profits overseas to avoid paying billions in state taxes every year. AB 1790 will even the playing [field] and end the Water's Edge tax loophole to return California to a system that fairly taxes multinational corporations.

- 2) **Background. *Water's Edge.*** When a business derives income from sources both within and outside California, it is necessary to determine the portion of total income attributable to the state for taxation purposes. California utilizes the unitary business principle to determine the appropriate tax base by first defining the scope of the unitary business and then apportioning the total income of that unitary business between California and the other jurisdictions in which the business operates. The business income of all affiliates comprising the unitary group is reported to California on a "combined report."

Existing law, the "water's-edge" election, allows a unitary group to either file on a worldwide combined reporting basis or to elect to calculate California income and activities on a water's-edge basis. Thus, the election allows a business to exclude income of certain foreign subsidiaries from the business's tax base, likely reducing the business's tax liability. However, a water's-edge election requires the taxpayer file on such a basis for a statutory election period of at least seven years and follow certain income reporting rules, meaning there may be certain tax years when the election results in increased tax liability for the business, to the extent there is fluctuation of profits and losses within the reporting group. This bill prohibits a taxpayer from making a water's-edge election or filing on a water's-edge basis for taxable years beginning on or after January 1, 2028.

Single-Sales Factor and NCTI Conformity. This bill also modifies the base of income that must be reflected in a water's-edge filer's combined report prior to the 2028 prohibition. This bill requires a water's-edge combined report to include the entire income and

apportionment factors of any corporation, other than a bank, regardless of the corporation's place of incorporation, if the corporation's sales factor within the U.S. is 20% or more. Currently, a water's-edge filer is required to include the income and apportionment factors of a corporation only if the average of the corporation's property, payroll, and sales factors within the U.S. is 20% or more. Thus, generally, if a corporation's sales in the U.S. comprise 20% or more of the corporation's global sales, the corporation must be included within the water's-edge combined report.

Additionally, this bill requires a water's-edge combined report to include as business income 40% of NCTI. NCTI requires a U.S. shareholder owning at least 10% of a CFC to pay annual federal tax on the shareholder's share of the corporation's profits, even if those profits have not been distributed. This provision of federal law is designed to prevent federal taxpayers from avoiding tax by keeping income in low-tax foreign jurisdictions, essentially ensuring a minimum tax is paid on foreign earnings. Because these two new reporting requirements would likely result in many water's edge filers having substantial additional income in their combined reports, this bill authorizes a taxpayer to terminate the taxpayer's seven-year water's-edge election without the FTB's consent for any taxable year beginning on or after January 1, 2026, and before January 1, 2028.

- 3) **Support and Opposition.** This bill is supported by a large coalition of labor organizations and social justice groups, led by SEIU California, which argues, "This bill would ensure that corporations pay the taxes they owe by closing a corporate tax loophole that allows them to hide their billions in offshore accounts and not pay taxes on profits that Californians helped them generate." This bill is also supported by a large coalition of environmental, public health, and community groups, which argues the state "faces serious fiscal pressures and potential reductions in federal support for healthcare, education, food assistance, environmental protection, and disaster response," so "restoring this revenue source is a necessary and responsible step to protect the state's most vital programs."

This bill is opposed by a large coalition of business groups, led by the California Taxpayers Association, which argues this bill "would significantly increase taxes on many companies that do business in California and reignite a trade war that was avoided in the past only thanks to the very policy this legislation seeks to upend." This bill is also opposed by the Governments of Canada, France, Germany, Iceland, Ireland, Japan, the Republic of Korea, Ukraine, and the United Kingdom, which raise concerns regarding the risk of double taxation as multi-national companies "include in their California taxable base income that has already been subject to tax in our respective jurisdictions," regulatory compliance burdens, federal-state tax policy harmonization, and investment planning and confidence.

- 4) **Prior Legislation.** AB 71 (Luz Rivas), of the 2021-22 Legislative Session, would have required a taxpayer making a water's-edge election to take into account 50% of global intangible low-taxed income (precursor to NCTI) and 40% of the repatriation income of the taxpayer's affiliated corporations, with revenues used to support homelessness programs. AB 71 was ordered to the Assembly Inactive File.