



MULTISTATE INCOME/FRANCHISE TAX

California Legislature proposes repeal of water's-edge election

Tax Alert

Overview

On February 10, 2026, California lawmakers introduced [Assembly Bill 1790](#) (A.B. 1790), which would modify California's water's-edge combined reporting regime and ultimately repeal the water's-edge election beginning with taxable years beginning on or after January 1, 2028. A.B. 1790 would also impose interim changes for taxpayers that continue to file on a water's-edge basis for tax years beginning on or after January 1, 2026 and before January 1, 2028, including changes related to controlled foreign corporation ("CFC") income and the scope of entities included in the combined group.

A.B. 1790 is designated as a tax levy that would result in a taxpayer paying higher taxes within the meaning of the California Constitution and, as such, would require approval by a two-thirds vote of each house of the legislature. This Tax Alert summarizes some of the relevant provisions of A.B. 1790.

Background

Under current California law, a unitary business group generally computes income on a worldwide combined reporting basis but may elect to determine California taxable income on a water's-edge basis. A water's-edge election typically limits the combined group to U.S. entities and certain foreign affiliates where the average of the affiliate's property, payroll, and sales factors within the United States is 20 percent or more. Once made, a water's-edge election generally remains in effect for 84 months, subject to limited termination provisions.

Repeal of water's-edge election beginning in 2028

As proposed, A.B. 1790 would terminate all existing water's-edge elections for the first taxable year beginning on or after January 1, 2028. For taxable years beginning on and after January 1, 2028, taxpayers would no longer be permitted to make a water's-edge election or file on a water's-edge basis, effectively requiring worldwide combined reporting for unitary business groups.

Transition rules

For taxable years beginning on or after January 1, 2026, and before January 1, 2028, A.B. 1790 would retain the availability of the water's-edge filing method but with significant modifications. These modifications would require inclusion of the following items in the water's-edge combined reporting:

- Forty percent of net CFC tested income (as defined under Internal Revenue Code 951A) would be required to be included as business income. No apportionment factors of the CFC would be included because of this income inclusion.

- The entire income and apportionment factors of any corporation (other than a bank) whose U.S. sales factor is at least 20 percent would be included, replacing the current test based on the average of U.S. property, payroll, and sales factors.
- The entire net income and apportionment factors of any captive insurer that is part of the unitary business would be included in the combined report.

Termination of existing elections without Franchise Tax Board consent

For taxable years beginning on or after January 1, 2026 and before January 1, 2028, A.B. 1790 would allow any taxpayer with an existing water's-edge election to terminate that election without the consent of the Franchise Tax Board.

Considerations

The California Legislature has considered similar proposals in prior years that would have modified or repealed the water's-edge election, none of which were enacted. Given the range of stakeholder interests implicated by A.B. 1790, the bill is expected to be subject to significant public comment and legislative review as it moves through the legislative process, which may result in amendments or other revisions to the bill's current language.

In addition, because A.B. 1790 could materially affect taxpayers that currently file on a water's-edge basis, affected taxpayers should consider consulting with their tax advisors to evaluate the potential impact of the proposed changes, including modeling the effect on California income tax liability if the bill were enacted as introduced.

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