



# **Mandatory Worldwide Combined Reporting: Elegant in Theory but Harmful in Implementation**

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The Council On State Taxation (COST) is a nonprofit trade association consisting of over 500 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

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The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST). For more information on STRI, please contact Douglas L. Lindholm at [dlindholm@cost.org](mailto:dlindholm@cost.org).

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# Mandatory Worldwide Combined Reporting: Elegant in Theory but Harmful in Implementation

By Douglas L. Lindholm and Marilyn A. Wethekam<sup>1</sup>

## I. Introduction

In the complex and variegated world of state corporate income taxation, few issues have been more controversial than state imposition of mandatory worldwide combined reporting to apportion corporate income for state tax reporting purposes. Although most states yielded on the issue decades ago and now allow unitary taxpayers a water's-edge election,<sup>2</sup> a recent resurgence of attention to the once-discredited reporting method by certain academicians and policymakers has brought the method back to the forefront of state tax policy controversy.<sup>3</sup> This paper evaluates the use of mandatory worldwide combined reporting as a return filing method, and concludes that, although permissible under the U.S. Constitution, it is undesirable for practical, equitable, and competitiveness concerns.

The Uniform Division of Income for Tax Purposes Act (UDITPA),<sup>4</sup> promulgated in 1957 by the precursor to the Uniform Law Commission, calls for apportionment of corporate income (as opposed to separate geographic accounting) because of the difficulty of accurately sourcing income among the taxing jurisdictions where a multistate or multinational corporation may operate. As a proxy for a company's presence, UDITPA initially called for measuring a company's presence in a state by using three equally weighted factors – the company's payroll, property, and sales.<sup>5</sup> These in-state amounts were compared to total amounts of property, payroll, and sales, and these fractions were added together to develop an apportionment percentage. The corporation's total income is then multiplied by that percentage to determine apportionable income (most states have since moved to single sales factor apportionment formula). In the 1970's, states began looking at a unitary group of corporations as a single entity and applied the total group's apportionment percentage to the total group's income, using a "unitary theory" of apportionment which treats all such affiliates as integral parts of a single taxable entity, instead of

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<sup>2</sup> Alaska is the only state that still requires mandatory worldwide combined reporting, but the State imposes the method only on oil companies with exploration and production facilities or ownership of a pipeline interest in the state. "Water's-edge" refers to the use of only domestic factors applied to income earned within the domestic "water's-edge."

<sup>3</sup> See, e.g., Darien Shanske *et al.*, *Law Professors Letter on Worldwide Combined Reporting in Minnesota*, Maurer School of Law, Research Paper No. 504 (2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4446650](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4446650); and see Michael Mazerov, *Minnesota Bill Marks Major Step Forward in Preventing Multinational Corporations from Shifting Profits Abroad*, Center on Budget and Policy Priorities (May 8, 2023), <https://www.cbpp.org/blog/minnesota-bill-marks-major-step-forward-in-preventing-multinational-corporations-from-shifting>; see also Richard Phillips, *A Simple Fix for a \$17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens*, ITEP (Jan. 17, 2019), [A Simple Fix for a \\$17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens – ITEP](https://www.itep.org/publications/a-simple-fix-for-a-17-billion-loophole-how-states-can-reclaim-revenue-lost-to-tax-havens); but see H.B. 121, 2023 Leg. Sess. (NH 2023) (Inexpedient to Legislate), H.B. 149, 32 Leg. Sess., (HI 2023), H.B. 2674, 82 Leg., 2023 Reg. Sess. (OR 2023). The Vermont House Ways and Means Committee has also heard testimony on draft language for a proposal to adopt mandatory worldwide combined reporting, with no bill yet submitted.

<sup>4</sup> *Uniform Division of Income for Tax Purposes Act*, National Conference of Commissioners on Uniform State Laws (1957), <https://www.uniformlaws.org/viewdocument/final-act-54?CommunityKey=f2ef73d2-2e5b-488e-a525-51be29fbee47>.

<sup>5</sup> Many states have modified UDITPA to apportion income based on a single sales factor or a heavily weighted sales factor.

calculating apportionment for each individual entity in a multinational group. The concept of unitary formulary apportionment, in the abstract, is thus elegant in its mathematical simplicity and theoretical precision. However, when applied in a global context – using worldwide factors to apportion the global income of multinational entities – serious practical questions about equity, economic competitiveness, and complex administrative difficulties quickly muddy the calculation.

In the “Origins of the Unitary Theory of Apportionment” section set forth in the Appendix, below, we note that one of the first complexities was how to define “corporate taxpayer” as articulated in UDITPA and state taxing statutes. In the early 19<sup>th</sup> century, property tax cases adopted the “unit rule” for valuation purposes. Subsequently, tax administrators at the California Franchise Tax Board, affirmed by California courts, utilized the “unit rule” in formulating the concept of “unitary taxation” – the idea that separately incorporated companies that are significantly interrelated should be treated for tax purposes as part of a single “unit”; *i.e.*, as a single taxpayer. California tax administrators then applied this “unit” concept to the State’s corporate income (franchise) tax to redefine “company” or “corporation” in State tax statutes – not as a reference to a single legal entity, but to encompass any group of sufficiently interrelated entities that should be taxed under a single “combined unitary” tax return. Despite years of litigation, the courts have still insufficiently refined the tests for accurately and consistently defining “unity.” State policymakers have been reluctant to enact specific definitions of unity (essentially a constitutional determination) for fear of exceeding constitutional bounds or not fully reaching the limits of the Constitution, wherever that may lie, thus leaving potential income untaxed.

A more significant complication, and the topic of this paper, arose when California tax administrators began to address the scope of the companies that should be included in a unitary group, and postulated that the apportionment percentage for determining income apportionable to a single state should be based on a *global* calculation of income, multiplied by a *global* calculation of the factors that contribute to that multinational taxpayer’s income. Thus, the concept of worldwide combined reporting was born – a filing methodology that required large multinational taxpayers to calculate the precise location of their *global* economic factors – property, payroll, and sales – as a means of determining how much of the company’s *global* income should be apportioned to a specific state. And this was to be undertaken in the face of differing domestic and foreign accounting principles, exchange rate fluctuations, inflationary differences, differing levels of profitability, and numerous other domestic/foreign distinctions that can only be resolved through “best guess” scenarios. Unfortunately, the arbitrary nature of these calculations undermines the requisite certainty and predictability of effective tax statutes, and of the ensuing audits of companies under those statutes.

Not surprisingly, the imposition of mandatory worldwide combined reporting in the 1970s was challenged by taxpayers subject to the reporting method, first by domestic-headquartered companies with

foreign subsidiaries (outbound) in 1983,<sup>6</sup> and ultimately by foreign-based headquarter companies with subsidiaries operating within the United States (inbound) in 1994.<sup>7</sup> In both cases the Supreme Court upheld the filing method as fair apportionment under the Constitution, and “within the realm of a permissible judgment.”

The Court’s acquiescence to the worldwide combined reporting method, however, was not the end of the controversy, but rather heralded the beginning of a deeper examination of the compliance and foreign policy implications of the tax scheme. In response to the Court’s initial decision in *Container*, numerous countries – significant trading partners of the U.S. – expressed their displeasure at the use of the filing method by California and other states.<sup>8</sup> Within six months of the *Container* decision, the clamor from taxpayers and threats of retaliatory taxation from those trading partners was so great that President Ronald Reagan, in an effort to defuse the controversy, appointed a Working Group with representation from significant stakeholders (multinationals, business groups, state tax groups, state and federal politicians, and the U.S. Treasury) led by President Reagan’s Treasury Secretary, Donald Regan.<sup>9</sup> Although not unanimous in its recommended solution, after 145 hours of meetings on 20 separate days, the Working Group ultimately reached consensus on three broad principles: 1) limit the states’ unitary taxation for both U.S. and foreign based companies to the water’s edge; 2) increase federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and 3) ensure competitive balance between U.S. multinationals, foreign multinationals, and purely domestic businesses. These principles have provided the foundation for state corporate income taxation of multinational entities that has largely survived to the present day.<sup>10</sup>

In this paper we examine the reasons why mandatory worldwide combined reporting is a current topic of discussion before several state legislatures and discuss why a return to the once-discredited filing method will be harmful to states and our national economy from a compliance and competitiveness perspective. **Part II** discusses the unique history of worldwide combined unitary reporting and how it morphed into existence through state application of the unitary theory on purely domestic affiliated groups of companies. It also recounts the efforts of the Reagan Administration in the 1980s, in response to state imposition of mandatory worldwide combined reporting, to defuse the threats of retaliatory taxation by some of the nation’s strongest trading partners and complaints from domestic and foreign multinational

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<sup>6</sup> In *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), the Court affirmed the fairness of California’s taxing of the business’ unitary domestic and foreign activities, the tax being held fairly apportioned and not otherwise preempted by federal law.

<sup>7</sup> In *Barclay’s Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994), the Court affirmed that California’s corporate franchise tax did not unduly burden foreign-based multinational entities with a double-tax, and therefore did not violate the Commerce Clause or otherwise frustrate the federal government’s ability to regulate foreign commercial relations.

<sup>8</sup> See, *Barclay’s Bank PLC v. Franchise Tax Board*, FN 22, citing a January 30, 1986, letter from Secretary of State George Schultz to California Governor Deukmejian: “The Department of State has received diplomatic notes complaining about state use of the worldwide unitary method of taxation from virtually every developed country in the world.” See also, FN 13.

<sup>9</sup> Worldwide Unitary Taxation Working Group, Chairman’s Report and Supplemental Views (August 1984).

<sup>10</sup> Several states over the past few years have studied and/or considered the adoption of mandatory worldwide combined reporting and have rejected the approach. Legislatures in Hawaii, Indiana, Maine, and Minnesota have all rejected such legislation (see, FN 3). The most recent in-depth study and rejection of the filing methodology took place in New Hampshire: See Rep. Walter Spilsbury, Chairman, *Final Report of the Commission on Worldwide Combined Reporting for Unitary Businesses Under the Business Profits Tax*, (November 2023). Available at: [Worldwide Combined Reporting Final Report 2023.pdf \(state.nh.us\)](#).

businesses about the use of mandatory worldwide combined reporting, through the development of a “water’s-edge” compromise that has stood for nearly forty years.

**Part III** examines one of the primary justifications by proponents for imposing mandatory worldwide combined reporting at the state level – to recoup revenues ostensibly “lost” through global profit shifting – and examines efforts started a decade ago by the international tax community, led by the Organisation for Economic Cooperation and Development (OECD), to address and combat what was rapidly becoming a global problem.<sup>11</sup> The section also discusses why early estimates of global profit shifting were widely disparate, and how the OECD’s continued progress toward implementing a global minimum tax now mitigates the need for individual states to impose an outdated and burdensome reporting method on U.S. taxpayers.

**Part IV** identifies and examines the faulty assumptions underlying widely quoted state revenue estimates of imposing mandatory worldwide combined reporting and discusses the weaknesses in the proponents’ remaining arguments for imposing the filing methodology. **Part V** examines the compliance burden that mandatory worldwide combined reporting imposes on both multinational taxpayers and state departments of revenue and explains how any anticipated state revenue increases derived from the reporting method are far from certain, particularly after the foreign factors are included in the apportionment calculation. **Part VI** concludes.

Authors’ Note: The **Appendix** to this paper contains an overview of the history and development of the unitary theory as an income apportionment mechanism that initially was applied only to domestic U.S. companies but was imposed on a worldwide basis by states beginning in the 1970’s (notably California) as international commerce (and multinational entities) began to flourish in the latter half of the twentieth century.

## **II. The Rise and Demise of Worldwide Combined Unitary Reporting in the 1980s**

Many states that impose a corporate income tax require affiliated groups of corporations to apportion corporate income on a combined unitary reporting basis when filing state corporate income tax returns. “Unitary combined reporting” is based on the premise that if affiliated companies are sufficiently interrelated, all such entities should apportion income among the states as a single unit based on the related group’s income and apportionment factors.<sup>12</sup> As discussed in greater detail in the “Origins of the Unitary Theory of Apportionment” section in the Appendix, the unitary theory was an outgrowth of property tax cases in the late nineteenth and early twentieth century that recognized taxation of the entire “unit” of sufficiently interrelated companies. Whether an entity may be part of the group apportionment

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<sup>11</sup> *Tax Challenges Arising from Digitalisation of the Economy - Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD (2021), <https://doi.org/10.1787/782bac33-en>.

<sup>12</sup> For a complete history of the development of the concept of formulary apportionment based on the unitary theory, see the Appendix to this paper, starting on page 26.

hinges on whether the entity or entities are sufficiently interrelated, *i.e.*, are unitary with each other. The concept of “unitary,” however, is uniquely poorly defined because its origins lie in numerous court cases over several decades.

In the latter half of the twentieth century, as international commerce (and multinational entities) began to flourish, several states (led by California) sought to implement mandatory unitary combined reporting on a global basis against multinational entities conducting business in the state through domestic affiliates. Known as “worldwide combined reporting” (WWCR), the theory, an outgrowth of the domestic unitary method, applies the concept of unity on a global scale. Mandatory WWCR thus postulates that income attributable to a single state should be based on a calculation of the affiliated group’s combined *global* income multiplied by the ratio of *global* factors that contribute to the production of the affiliated group’s global income. The implications of this global reach are broad – losses or income incurred by foreign affiliates in the multinational group would impact the amount of tax paid to California, when the only connection to California was through a domestic affiliate conducting business in California which itself had no connection to the foreign affiliates other than a “unitary” linkage. Not surprisingly, state imposition of mandatory WWCR ultimately led to numerous court challenges arising out of the complexity of the compliance burden, the mismatch of foreign and domestic tax rules and accounting standards, and the foreign policy implications of subjecting international groups to subnational (state) taxation.

Although California had imposed the unitary method of taxation since the 1930’s, it was not until the early 1970’s that California began to apply the concept to foreign multinational corporations. The expansion of the use of unitary taxation to foreign multinationals created a significant controversy with international trading partners of the United States.<sup>13</sup> The contentions first arose during Senate debate on the United States-United Kingdom Tax Convention, a treaty initially signed on December 31, 1975.<sup>14</sup> In direct response to California’s extension of worldwide combined taxation to foreign multinationals,

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<sup>13</sup> A letter appended to the Working Group Report (see FN 45, *infra*) by Allen Wallis, President Reagan’s Under Secretary of State for Economic Affairs, describes the extent of the controversy:

“The unitary method of estimating taxable income has provoked sharp criticism from all of our major trading partners. Indeed, Secretary Shultz has said that in his tenure at the State Department few issues have provoked so broad and intense a reaction from foreign nations. The United States Government has received diplomatic notes from fourteen member countries of the Organization for Economic Cooperation and Development (OECD), either directly or through the European Community, as well as communications from the OECD itself, all protesting against the application of the unitary tax method to their companies. The OECD countries account for nearly 90% of foreign direct investment in the United States, over 70% of total United States investment abroad and over 80% of United States trade (OECD figures). Representations have been made at the highest level. The Prime Ministers of three of our largest trading partners have written to the President to express their concern and have raised the issue in personal meetings with him. The Foreign Ministers of these countries also have raised the issue with Secretary Shultz....

“Foreign governments have informed us that, “The [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market.” In their view a unitary tax constitutes “...a serious obstacle to the further development of our trade and investment relationships.” (Note signed by the Ambassadors of fourteen of our major trading partners). There have also been calls for retaliation. Added to this are the statements from foreign business organizations like the Keidanren, which represents over 800 Japanese corporations: “Unitary taxation is the single most serious deterrent to new investment by Japanese enterprises in some states of the United States.” The French Patronat, which represents a wide range of the biggest French industries with investment in the United States, described the unitary taxation method in a demarche to our Ambassador in Paris as “...not suited to the reality nor to the development of foreign investment, particularly between industrialized countries.”

<sup>14</sup> 31 U.S.T. 5670, TIRS No.9682.



including British multinationals, clause 9(4) was added to the treaty,<sup>15</sup> which essentially barred the use of worldwide combined reporting to determine the taxation of a United Kingdom controlled corporation. The 9(4)-clause met with serious opposition when the treaty reached the Senate Foreign Relations Committee. On June 27, 1978, the Senate approved the treaty subject to the reservation of clause 9(4). The treaty was subsequently approved by the British Parliament, after the Carter Administration offered assurances that the worldwide combined reporting issue would be resolved.<sup>16</sup>

In the wake of the *Container* decision upholding worldwide combined reporting for domestic multinationals<sup>17</sup>, members of the business community and several of the U.S.'s foreign trading partners renewed their objections to the use of the worldwide unitary method. Specifically, the Reagan administration was pressed to (1) support the rehearing request in *Container* by filing an *amicus* brief; and (2) support federal legislation that would limit or prohibit the use of worldwide combined reporting by the states. In response to the requests, a Cabinet Council on Economic Affairs ("CCEA") Working Group was formed in July 1983 to identify the federal and state government interests in the worldwide combined reporting method and develop potential options. The CCEA Working Group developed a series of options which were forwarded to President Reagan for a decision. In response, Secretary of the Treasury Donald Regan, on September 23, 1983, announced the formation of the Worldwide Unitary Taxation Working Group ("Working Group") composed of federal and state officials and representatives of the business community.<sup>18</sup> The Working Group, chaired by Secretary Regan, was "charged with producing recommendations . . . that will be conducive to harmonious international economic relations, while respecting the fiscal rights and privileges of the individual states."<sup>19</sup> The Working Group members were announced on October 28, 1983, and held their first meeting on November 2, 1983.<sup>20</sup> At that meeting the Working Group set up a technical level Task Force consisting of representatives of the Working Group

<sup>15</sup> 31 U.S.T. 5677.

<sup>16</sup> After the ratification of the United Kingdom/U.S. Tax Treaty, H.R. 5076 (96<sup>th</sup> Congress 2d. Session (1980)) was introduced. The bill would have essentially barred the states' use of worldwide combined reporting. This bill was just one of several bills dating back to 1965 which would have restricted the use of combined reporting. Some of these bills are listed below:

H.R. 11798 (Willis) (1965)	S. 1688 (Mathias) (1979)	H.R. 6402 (Rodino) (1982)	H.R. 6146 (Mica) (1984)
S. 916 (Ribicoff) (1969)	H.R. 5076 (Conable) (1979)	H.R. 2918 (Conable) (1983)	S. 3061 (Hawkins) (1984)
S. 317 (Ribicoff) (1971)	H.R. 5903 (Satterfield) (1979)	H.R. 3243 (Frenzel) (1983)	H.R. 3980 (Duncan) (1985)
S. 4080 (Mathias) (1972)	H.R. 8277 (Broyhill) (1980)	S. 1225 (Mathias) (1983)	S. 1113 (Mathias) (1985)
S. 2173 (Mathias) (1977)	H.R. 1983 (Conable) (1981)	H.R. 4940 (Wyden) (1984)	S. 1974 (Wilson) (1985)

<sup>17</sup> For a deeper dive into the numerous cases that led to the Supreme Court's acquiescence to California's use of mandatory worldwide combined reporting in *Container* (1983), and *Barclays / Colgate-Palmolive* (1994), see Appendix, *infra*, on p.26.

<sup>18</sup> It was announced that the federal government would not support a rehearing in *Container*.

<sup>19</sup> *Chairman's Report on the Worldwide Unitary Taxation Working Group: Activities, Issues, and Recommendations*, Office of the Secy of the Dept. of the Treas. (Aug. 1984) at 5, <https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/other-state-tax-studies-articles-reports/worldwide-unitary-taxation-working-group-final-report.pdf>.

<sup>20</sup> The 20 Members of the Working Group were:

Donald T. Regan <i>U.S. Treasury Secretary</i>	George Deukmejian <i>Governor of California</i>	Philip Caldwell <i>Chair &amp; CEO, Ford Motor Co.</i>	Owen L. Clarke <i>Pres., Nat'l Assoc. of Tax Admin'rs</i>
Robert Hawkins <i>Adv. Comm'n on Intergov. Rel.</i>	Robert E. Gilmore <i>Pres., Caterpillar Tractor Co.</i>	John R. Opel <i>Chair &amp; CEO, IBM Corp.</i>	David E. Nething <i>VP, Nat'l Conf. of St. Legislatures</i>
Norma Pace <i>Sr. VP, Am. Paper Inst.</i>	Clifton C. Garvin, Jr. <i>Chair., Exxon Corp.</i>	James R. Thompson <i>Governor of Illinois</i>	John B. Tucker <i>House Speaker, New Hampshire</i>
Charles I. McCarty <i>Chair &amp; CEO, BATUS, Inc.</i>	H. Lee Moffitt <i>House Speaker, Florida.</i>	Kent Conrad <i>Chair, Multistate Tax Comm'n</i>	Edmund T. Pratt, Jr. <i>Chair, Pfizer, Inc.</i>
Peter A. Magowan <i>Chair &amp; CEO, Safeway Stores, Inc.</i>	Allan Wallis <i>Und. Sec. of State for Econ. Affairs</i>	Scott M. Matheson <i>Governor of Utah</i>	John Svahn <i>Asst. to Pres. for Pol. Development</i>

members. The role of the Task Force was to thoroughly review the issues and develop options for consideration by the Working Group. Both the Working Group and the Task Force agreed to defer consideration of preemptive or restrictive federal legislation and rather focus on voluntary state actions.

The Task Force held 145 hours of meetings, heard testimony from 47 separate individuals and groups, and received written comments from private individuals, state government representatives, business groups, and various foreign governments.<sup>21</sup> As a result of this work, the Task Force presented six options for the Working Group's consideration.<sup>22</sup> The Working Group could not reach a consensus on the options and on July 31, 1984, transmitted the Chairman's Report to President Reagan. Although consensus on the six options was not achieved,<sup>23</sup> the Working Group nevertheless concluded in its Report that the design of state corporate income tax policy should adhere to three basic principles:

- 1) Water's-edge unitary combination for both U.S. and foreign based companies. This was to be implemented by state action rather than federal restrictions.
- 2) Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability. This would be achieved by adopting a domestic disclosure spreadsheet providing for an exchange of information, and federal assistance to any state that did not require worldwide reporting. Additionally, the Internal Revenue Service would increase its resources devoted to international enforcement issues and would undertake a joint study on the application of the Section 482 regulations.
- 3) A competitive balance should be achieved for U.S. multinational, foreign multinational, and domestic businesses. State tax policy should maintain a competitive balance among all business taxpayers.

On August 30, 1984, Secretary Regan transmitted to President Reagan the Final Report of the Worldwide Unitary Taxation Working Group.<sup>24</sup> While the final report did not recommend immediate federal action. Secretary Regan's transmittal letter noted that if "the states enact legislation based on the three principles agreed upon by the Working Group, the United States will be able to speak with one voice in

<sup>21</sup> The governments of Australia, Belgium, Canada, Germany, Netherlands, Switzerland, United Kingdom, the European Community, and the European Commission provided written statements. *Id.* at 6. The Council On State Taxation (COST), then known as the Committee on State Taxation (COST) of the Council of State Chambers of Commerce, submitted comments and testified before the Working Group on November 30, 1983 in support of the business position outlined in the report.

<sup>22</sup> The six options provided by the Working Group were as follows:

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|--|---|---|
| (1) Alternative Activities Tax In lieu of Unitary Apportionment Solely for Foreign-Based Multinationals. | (2) Comprehensive Water's Edge Combination with Taxation of Foreign Dividends, Without the Gross-Up of Foreign Taxes Computed for the Federal Foreign Tax Credit. | (3) Comprehensive Water's Edge Combination with Taxation of Foreign Dividends, with Factor Relief and with the Gross-Up of Foreign Taxes Computed for the Federal Foreign Tax Credit. |
| (4) Modified Water's Edge Combination with Exclusion of Foreign Dividends.                               | (5) Modified Water's Edge Combination with Special "Foreign Income" Rule.   | (6) Comprehensive Water's Edge Combination with "Nondiscriminatory" Treatment of Intercorporate Dividends.  |

<sup>23</sup> Additionally, the Working Group could not reach a consensus on the taxation of foreign-source dividends and the taxation of U.S. corporation operating primarily abroad, i.e., "80/20" companies.

<sup>24</sup> The final report contains a supplement which sets forth the views of individual Working Group members.

dealing with its foreign trading partners, and this irritant to international commercial relations will have been eliminated.”<sup>25</sup>

At the time the Working Group Report was issued, twelve states utilized the worldwide combined unitary reporting method.<sup>26</sup> Within a decade, all twelve states discarded a statutory requirement for mandatory worldwide combined reporting (other than Alaska, which still applies the concept solely to oil and gas interests). Subsequent to the issuance of the Working Group report the states of Colorado, Florida, Idaho, Indiana, New Hampshire, and Oregon repealed the use of the worldwide combined reporting method.<sup>27</sup> A judicial decision in Massachusetts found the practice to be unauthorized.<sup>28</sup> In Utah, an administrative regulation was promulgated that would adopt a "water's-edge" approach but only if the federal government carried out the second principle of the Working Group Report.<sup>29</sup> In 1986, California enacted legislation that allowed multinational corporations to make a water's-edge election as an alternative to worldwide unitary taxation in computing a business's taxable income.<sup>30</sup> Alaska, Montana, and North Dakota also either repealed the worldwide filing requirements or provided for a water's-edge election.<sup>31</sup>

The relative equilibrium thus achieved by the Working Group recommendations between U.S. states, the Federal Government, the business community, and foreign trading partners of the U.S. has prevailed for nearly forty years. Recent state legislative actions seeking to impose mandatory worldwide combined reporting have once again brought the issue to the forefront of state tax policy controversy.<sup>32</sup>

### **III. Global Profit Shifting is an International Problem; the Solution is Through Harmonized International Rules**

In the forty years since the Working Group reached its compromise on mandatory worldwide combined reporting, the states largely respected the compromise and refrained from imposing the filing methodology. If a state chose to adopt unitary combined reporting during this period, it was either

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<sup>25</sup> Additionally, the transmittal letter made clear if there were no significant signs of appreciable progress by the states in this area within a year the Secretary would recommend legislative or administrative action. Chairman's Report transmittal letter dated July 31, 1984. Substantial progress at the state level was not achieved, and on December 19, 1985, the Treasury Department proposed legislation that would prohibit the use of worldwide combined reporting. S.1974 (99<sup>th</sup> Cong. 1<sup>st</sup> Sess. (1985)) and H.R.3980 (99<sup>th</sup> Cong. 1<sup>st</sup> Sess. (1985)).

<sup>26</sup> The 12 states were: Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon, and Utah.

<sup>27</sup> FLA. STAT. § 220.135 (repealed), § 220.03, § 220.131, and § 220.12(b); BNA Daily Tax Rep. No. 59, G-1 (Mar. 27, 1986); IND. CODE §§ 6-3-2(o) (2019), 6-3-2-2.4(a) (2022); ST. TAX REP. (CCH) 95-149(a) and 95-150; BNA Daily Tax Rep. No. 96, G-1 (May 19, 1986); OR. REV. STAT. §§ 17.010(3), 314.363. See 2 (Or.) ST. TAX REP. (CCH) 199-010.; BNA Daily Tax Rep. No. 39, G-4 (Feb. 27, 1986).

<sup>28</sup> *Polaroid Corp. v. Comm'r of Revenue*, 393 Mass. 490 (1984).

<sup>29</sup> Utah State Tax Comm'n Rul. No. A 12-01-F8A, 1 11-712 (1985); see [Utah] ST. TAX REP. (CCH).

<sup>30</sup> CAL. Rev. & Tax § 25110. The statute was to be effective January 1, 1988. Initially, California required corporations making a water's-edge election to enter into a five-year contract, agree to pay a fee, and file a domestic disclosure spreadsheet with the State. Subsequent amendments to the California statute eliminated the fee and the domestic disclosure spreadsheet requirements and extended the election period to 84 months.

<sup>31</sup> Corporations engaged in exploration or producing or operate a pipeline in Alaska are required to report corporate income tax on a worldwide combined reporting basis.

<sup>32</sup> See, e.g., Karl Frieden & Ferdinand Hogroian, *State Tax Haven Legislation: A Misguided Approach to a Global Issue*, STRI (Feb. 2016), Available at [state-tax-haven-legislation-a-misguided-approach-to-a-global-issue.pdf](https://www.stri.org/publications/state-tax-haven-legislation-a-misguided-approach-to-a-global-issue.pdf) (cost.org); See also, H.F. 1938, 93d Leg., 4<sup>th</sup> En (Minn. 2023); H.B. 102, Ch 12, Sess. 21-0078 (N.H. 2021).

imposed on a water's-edge basis with an option to file using worldwide factors and income, or on a worldwide basis with an election to file using factors and income limited to the domestic water's-edge.

Over the last decade, however, renewed interest at the state level in global formulary apportionment was awakened when the OECD initiated its BEPS Action Plan in 2013. BEPS was designed to “address tax avoidance and double non-taxation of Multinational Enterprise (MNE) profits by closing the gaps that had emerged in the international tax system in the wake of globalization and digitalization.”<sup>33</sup> Two years later, the OECD/G20 published its final BEPS Action Plan, which was endorsed by all of the G20 countries,<sup>34</sup> including the United States. Shortly thereafter, the OECD/G20 established the “Inclusive Framework on BEPS” – a consortium of over 140 countries working collaboratively on the implementation of 15 measures to address “tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.” On October 8, 2021, the Inclusive Framework countries released their “Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy,” detailing a two-pronged approach to international tax reform, with one prong focused on tax challenges arising from digitalization of the economy (Pillar 1) and the other prong focused on a global minimum tax designed to address global profit shifting (Pillar 2).

#### A. Pillar 1 – Taxation of the Digital Economy

Pillar 1 was specifically designed to address the issue of *nexus* in the international context. The states had largely succeeded in enforcing an “economic presence” nexus standard for income tax purposes in legislation and judicial decisions dating back to the 1990s. This approach was extended to sales and use taxes (and affirmed for income taxes) by the U.S. Supreme Court’s 2018 decision in *South Dakota v. Wayfair*.<sup>35</sup> However, international conventions still require a “permanent establishment” (PE) before taxing jurisdiction attaches. The primary goal of Pillar 1 is to circumvent the PE rule for the largest global corporations, and to allocate certain corporate profits (above a residual amount) to the market jurisdictions where customers and users are located (“Amount A”). Intensive work continues in the design of a “Multilateral Convention” to implement Amount A, which stakeholders hope will enter into force in 2025. In the interim, many countries have established a workaround – a tax on digital services and/or advertising – which allows the jurisdiction to capture income otherwise sourced to the headquarters location of the multinational entity contracting for the service or advertising.<sup>36</sup> As a key component of Pillar One, the Inclusive Framework countries have agreed to repeal or refrain from imposing newly

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<sup>33</sup> OECD/G20 Inclusive Framework on BEPS Progress Report, September 2022–September 2023. Available at [www.OECD.org](http://www.OECD.org).

<sup>34</sup> The G20 countries include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, and United States, plus the European Union and the African Union.

<sup>35</sup> *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).

<sup>36</sup> The proliferation of national digital services/advertising taxes has been seized upon by certain states to capture advertising-related income from large social media and technology companies. Unlike at the international level, however, such income is already taxable by states under current nexus and sourcing statutes. Such state-level taxes thus risk double taxation and numerous policy and constitutional challenges. See, Frieden and Lindholm: *Digital Services Taxes: A Bad Idea Under Any Theory*, (April 2023); Richard D. Pomp, *Resisting the Siren Song of Gross Receipts Taxes: From the Middle Ages to Maryland’s Tax on Digital Advertising*, (July 2022); and Frieden and Do, *State Adoption of European DSTs: Misguided and Unnecessary*, (May 2021). All three articles are available at [www.cost.org](http://www.cost.org).

enacted Digital Services Taxes or similar measures on any company prior to 2025, or earlier if the Multilateral Convention is adopted before that date.<sup>37</sup>

## **B. Pillar 2 – Global Minimum Tax on Corporate Income**

For purposes of weighing the relative merits of state adoption of mandatory worldwide combined reporting, Pillar 2 is of critical importance because it is specifically designed to minimize global profit shifting, and thus undercuts the primary justification (recouping “lost” state revenue) of proponents for state adoption of mandatory WWCR. Pillar 2 effectively proposes a 15% minimum tax on the income of large multinational entities in every country in which they operate. The global minimum tax (GMT), implemented through Global Base Erosion rules (GLoBE), would impose a rate of at least 15% on all a multinational group’s constituent entities – parents, subsidiaries, branches, or permanent establishments – in every country with a rate below 15%, by “topping-up” the country rate so that the entities’ effective tax rate is at least 15%. Although the right to impose a “top-up” tax is first granted to the source country, if the source country does not impose the tax, the home country of the parent company can collect the tax by increasing the income of the parent subject to tax (known as the income inclusion rule, or IIR). Finally, Pillar 2 imposes an undertaxed profit rule (UTPR) that specifies that if neither the source country nor the parent country chooses to impose the “top-up” tax, then the countries in which the MNE’s affiliates operate can choose to share the “top-up” tax that could have been levied in the source country.<sup>38</sup> GLoBE rules apply only to large multinational entities (MNEs) – those corporate groups with revenues exceeding 750 million Euros (approximately \$815 million in USD) in two of the previous four years.

Pillar 2 does not directly impose a minimum tax rate upon countries that impose a low tax rate. The OECD/G20 acknowledge that under Pillar 2 jurisdictions are still free to determine their own tax systems, including whether they have a corporate income tax and the level of their tax rates.<sup>39</sup> However, the operation of the IIR and UTPR allow the home country or the location of affiliates to collect a minimum tax if the source country chooses not to. This, of course, creates a natural incentive for the source country to impose a tax rate at least as high as the minimum tax under GLoBE rules. The Pillar 2 provisions thus fundamentally foster tax parity among countries by creating a global framework under which countries can impose additional tax on low-taxed foreign income of MNEs. To date, Pillar 2 has received a much greater response from the multinational community than has Pillar 1. As of December 2023, four countries have enacted the Pillar 2 minimum tax, twenty countries have drafted and are considering legislation, and an additional nineteen countries have declared their intentions to do so (see Table 1, below). Pillar 2 enactment by a significant number of Inclusive Framework countries, including the 27 members of the European Union, is expected in 2024.












































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<sup>37</sup> OECD/G20 Inclusive Framework on BEPS: Progress Report September 2022 - September 2023 (October 2023). Available at [www.oecd.org](http://www.oecd.org).

<sup>38</sup> The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy, Congressional Research Service, (September 2023).

<sup>39</sup> OECD/G-20 Inclusive framework on BEPS, *Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two*, at (October 2020).

Table 1: OECD Pillar 2 – Jurisdictional Implementation Activity

Enacted	Draft legislation			Intentions announced		
Japan 	Austria 	Ireland 	Slovakia 	Australia 	Indonesia 	South Africa 
Mauritius 	Canada 	Italy 	Slovenia 	Bahamas 	Isle of Man 	Spain 
South Korea 	Czech Republic 	Liechtenstein 	Sweden 	Belgium 	Jersey 	Taiwan 
UK 	Denmark 	Luxembourg 	Switzerland 	Bulgaria 	Lithuania 	Thailand 
	Finland 	Netherlands 	UK 	Gibraltar 	Malaysia 	UAE 
	France 	New Zealand 	Vietnam 	Guernsey 	Qatar 	
	Germany 	Norway 		Hong Kong 	Singapore 	

The significance of international receptivity to and adoption of a global minimum tax cannot be overstated. Ten years after the BEPS project started (in 2013), the promise of transformative international tax reform went from hypothetical to real. The adoption of Pillar 2 by a large number of Inclusive Framework nations will significantly reduce the incidence and revenue impact of global profit shifting. According to a January 9, 2024, OECD Taxation Working Paper,<sup>40</sup> because the GMT significantly reduces the incentives to shift profits, the global minimum tax will reduce global profit shifting by nearly 50%. More importantly, the percentage of profits in low-tax jurisdictions (those with tax rates below 15%) is expected to fall by two-thirds, with a concomitant increase in global corporate income tax revenues of nearly \$200 billion.<sup>41</sup>

### C. U.S. National Efforts to Reduce Global Profit Shifting

While many commentators deride the federal Tax Cuts and Jobs Act of 2018 (TCJA)<sup>42</sup> as a giveaway to wealthy individuals and large corporations, the Act “generated the most sweeping U.S. corporate tax policy changes since 1986”<sup>43</sup> and changed the international climate for profit shifting by enacting several features that acted as important precursors to the development of Pillar 2 by the OECD/G20.<sup>44</sup> Perhaps the most significant was the TCJA’s corporate income tax rate reduction of 35 percent to 21 percent, a change that took the U.S. federal tax rate from among the highest in the world to a rate much closer to the average of the rates in industrialized nations. The rate reduction itself reduced the incentive to shift

<sup>40</sup> See Felix Hugger et al., *The Global Minimum Tax and the Taxation of MNE Profit*, OECD Taxation Working Papers, (Jan. 2024).

<sup>41</sup> *Id.* at p. 52.

<sup>42</sup> The Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (codified as amended in scattered sections of 26 U.S.C.) (2017).

<sup>43</sup> See Kimberly Clausing et al., *Profit Shifting Before and After the Tax Cuts and Jobs Act*, (June 2020). Clausing notes that although GILTI, BEAT, and the rate reduction will reduce profit shifting, the territorial treatment of (some) foreign income and the elimination of the tax on repatriation may increase profit shifting incentives, albeit to a lesser extent. *Id.* at 27.

<sup>44</sup> See Karl A. Frieden and Barbara M. Angus, *Convergence and Divergence of Global and U.S. Tax Policies*, Special Report: Tax Notes State, Volume 101, pp. 937-975, (August 2021).

profits out of a high-tax jurisdiction (the U.S.) and into nearly any other country with a significantly lower rate. The other provisions of the TCJA specifically designed to address profit shifting are GILTI (Global Intangible Low-Taxed Income), and BEAT (Base Erosion Anti-Abuse Tax). The GILTI provision, which operates like an Income Inclusion Rule (see par. B., above), allows the U.S. to tax foreign income (above a 10 percent investment return) in countries that levy a low tax rate. The BEAT is essentially an alternative tax calculation that imposes a 10 percent tax on specific deductible payments to related foreign parties, but it does not function as a minimum tax because it applies without regard to the level of tax imposed on the payment in the recipient's home country and is added to the tax calculated under regular U.S. tax rules, thereby increasing total U.S. tax liability. The BEAT is credited as the precursor to the UTPR.<sup>45</sup> In addition to GILTI, BEAT, and the rate reduction, the Biden administration, as part of the Inflation Reduction Act, signed into law a 15 percent corporate alternative minimum tax (CAMT) on financial statement (book) income. The provision imposes a 15% minimum tax on corporations with average adjusted financial statement income in excess of \$1 billion over a three-year period. The alternative tax comes into play if the corporation's regular tax liability plus the BEAT is lower than the alternative minimum book income tax calculation. In this sense, the CAMT operates similarly to the third part of the GMT – the top-up tax in the low-tax country.<sup>46</sup>

#### **D. Subnational Efforts to Address Profit Shifting are Inappropriate and Would Make the US an Extreme Outlier Among Industrialized Nations**

Subnational taxation (state-level) of corporate income is common in the United States<sup>47</sup> but is not the norm in the other 48 industrialized nations in the OECD or G-20, which represent (together with the United States) nearly 90% of global gross domestic product. And it is rarer still to identify a country with subnational taxation of corporate income that includes foreign-source income in the subnational tax base. Indeed, of these 48 countries, only eight impose a subnational corporate income tax (CIT) – and only one of those eight (South Korea) subjects active foreign source income to subnational taxation in one large metropolitan area, at a maximum rate of 2.5 percent. In the other seven countries, foreign source income (typically foreign dividends) is either not subject to tax or 95 percent exempt from taxation.<sup>48</sup> The GMT similarly reflects this pattern, with adoption occurring (outside the United States) only at the national, and not subnational levels.

In the United States, however, a significant minority of states have strayed from the “water’s-edge” principle and included income earned from foreign sources in their corporate income tax bases. Over the past few decades, roughly one-third of all states have included a portion of foreign dividends (generally 25 percent or less) paid by foreign subsidiaries in their corporate income tax base. More recently, most of

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<sup>45</sup> *Id.* at 953-954.

<sup>46</sup> Inflation Reduction Act of 2022, Pub. L. No. 117-169 (passed under H.R. 5376; 117<sup>th</sup> Congress) (August 2022).

<sup>47</sup> Forty-four (44) states impose state-level corporate income taxes, with rates ranging from 2.5% in North Carolina to 11.5% in New Jersey.

<sup>48</sup> See, PricewaterhouseCoopers LLP, *Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income*, prepared for the State Tax Research Institute, (November 2019). Available at [www.cost.org](http://www.cost.org).



these states switched from taxing foreign dividends to conforming, in part, to federal GILTI. At the state level, about two-fifths of all states include a portion (ranging from 5 percent to 50 percent) of GILTI in their tax base. As Table 2 indicates, only two states (New Hampshire and Vermont) include in their tax base tax both 100 percent of foreign dividends and 50 percent of GILTI, while Minnesota now taxes 50 percent of foreign dividends and 50 percent of GILTI. While these deviations from the water's-edge combined reporting methodology are counterproductive policy choices from an economic competitive perspective, they stop short of discarding the water's-edge limitation and replacing it with a mandatory worldwide combined reporting system that would include all foreign source income in the state corporate income tax base.

Multinational companies headquartered in the United States compete for customers and resources on a global basis. The disharmony of our 50-state subnational tax system already imposes significant compliance and resource burdens greater than those imposed in countries without subnational taxation of corporate income. Although the federal rate reduction in the TCJA from 35 percent to 21 percent brings the U.S. closer to an international average, adding an additional 5 percent (on average) state CIT rate skews that achievement. The current federal tax rate on GILTI (10.5 percent after a 50 percent exclusion) is scheduled to increase to 13.125 percent after 2025. Further, because taxpayers are only allowed an 80 percent foreign tax credit on foreign source income added to the tax base by the GILTI inclusion, the current *effective* federal tax rate on GILTI for most taxpayers is already 13.125 percent and will increase to 16.406 percent after 2025.<sup>49</sup> Adding in the state-level taxation of GILTI thus increases the effective rate on GILTI higher than the 15 percent minimum tax sought by Pillar 2. Mandatory worldwide combined reporting, if enacted, would thus only exacerbate the already difficult competitive climate facing U.S. multinational companies.

#### **IV. State Revenue Estimates for WWCR are Largely Derived from a Single Misleading Report**

Nearly every state that has proposed mandatory worldwide combined reporting in the last five years<sup>50</sup> has cited the revenue estimates derived from a single 2019 Report, entitled "*A Simple Fix for a \$17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens*," by the Institute on Taxation and Economic Policy (ITEP) and the U.S. PIRG Education Fund, two liberal advocacy groups (hereinafter "ITEP Report").<sup>51</sup> The ITEP Report seizes on a 2018 mid-point estimate of global profit shifting it

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<sup>49</sup> Karl A. Frieden and Barbara M. Angus, "*Convergence and Divergence of Global and U.S. Tax Policies*," Tax Notes State, Aug. 30, 2021, at 955.

<sup>50</sup> Vermont has recently introduced draft language and heard testimony on adopting WWCR; New Hampshire's House of Representatives voted down H.B. 121 (Jan. 4, 2024) which would have mandated worldwide combined reporting; Maryland has referred H.B. 46 to the Ways and Means committee, which would implement a form of WWCR if passed; Hawaii introduced H.B. 149 (following the failed S.B. 1302), which has been referred to committee.

<sup>51</sup> Richard Phillips, *A Simple Fix for a \$17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens*, Institute on Taxation and Economic Policy (Jan 2019).



mistakenly attributes to the Congressional Budget Office (CBO),<sup>52</sup> and through a remarkable exercise in credibility laundering, extrapolates from that number to identify specific state-by-state revenue targets poised for inclusion in state coffers by making one of three “simple fixes” – adoption of unitary combined reporting by separate filing states, inclusion of specified “tax havens” in a water’s-edge unitary return, and/or adoption of mandatory worldwide combined reporting. The ITEP Report, unfortunately, thereby misleads readers by accepting as its starting point a number that is under continual revision by economists and academicians, and then proceeds downhill from there through several fatal errors in its extrapolation methodology. And yet the state-by-state revenues promised in the report are presented as a *fait accompli* – a “simple fix” – achievable merely by closing a few “loopholes.”<sup>53</sup>

#### A. Uncertainty as to Revenue Amounts Lost to Global Profit Shifting

Estimates of the true revenue impact of global profit shifting on U.S. revenues are particularly uncertain. Although quite literally dozens of thoroughly researched academic and government treatises have been written on the subject, a consistent or even a “ballpark” number continues to be elusive. The task is complicated by the use of differing data sets and economic approaches; the difficulty of separating profit shifting *among* industrialized countries from profit shifting solely out of the United States; the difficulty of isolating true profit shifting from revenue foregone in high tax rate countries caused by in-country tax incentives; the difficulty of separating true economic activity carried out in low-tax jurisdictions from artificially shifted profits; and the impact of federal rate reductions and other steps that reduce the incentive to shift profits. Although the numbers are uncertain, they are large enough to have spurred the international tax community, working through the OECD, to address the issue holistically, on a *global* basis, by seeking to ensure a minimum tax is paid on income from MNEs regardless of where earned. Notably, worldwide apportionment of MNE income has not been a part of that proposed solution.

The ITEP Report settles on a midpoint estimate between two prominent researchers whose estimates of profit shifting out of the U.S. are \$158 billion apart.<sup>54</sup> The \$158 billion discrepancy between the two estimates highlights the tremendous uncertainty surrounding estimates of global profit shifting and why such estimates should never be used as the basis for developing revenue estimates for states on such consequential legislation. Indeed, a recent paper by Professors Leslie Robinson (Tuck School of Business at Dartmouth) and Jennifer Blouin (Wharton School at UPenn)<sup>55</sup> suggests that due to double counting of tiered subsidiary profits, prevailing estimates of profit-shifting are overstated by nearly two-

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<sup>52</sup> CBO, *The Budget and Economic Outlook: 2018 to 2028*, Congressional Budget Office, Pub. 53651, at 127: “Profit shifting also lowers taxable corporate income in the United States—by roughly \$300 billion each year, *recent estimates from the economic literature suggest*” (emphasis added).

<sup>53</sup> ITEP Report, p. 14: (“If all states that tax corporate profits moved to a Worldwide Combined Reporting or Complete Reporting system, they would collect \$17.04 billion...”).

<sup>54</sup> The ITEP Report settles on a “midpoint” by citing an estimate by Professor Gabriel Zucman of \$142 billion, and an estimate by Professor Kimberly Clausing of nearly \$300 billion. ITEP Report, p. 17.

<sup>55</sup> Jennifer Blouin & Leslie Robinson, *Double Counting Accounting: How Much Profit of Multinational Enterprises is Really in Tax Havens?* (Sep. 2020), [Double Counting Accounting: How Much Profit of Multinational Enterprises Is Really in Tax Havens? by Jennifer Blouin, Leslie A. Robinson :: SSRN](#).

thirds.<sup>56</sup> Although this finding has been partially disputed in subsequent papers, the uncertainty surrounding estimates of global profit shifting – and their inappropriate use as a source of state revenue estimates – remains.

## B. Fatal Flaws in the ITEP Report's Extrapolation

Notwithstanding the uncertainty of the starting point for the ITEP Report's allocation of "lost" revenue to the states, the Report's allocation methodology contains several additional fatal flaws that severely discredit the accuracy and credibility of the Report's conclusions. These are listed and explained in greater detail, below:

- **No Foreign Factor Representation** – When a state seeks to include foreign income in the state tax base, it must also include the foreign factors (property, payroll, and/or sales) that generated that income in the denominator of the apportionment formula.<sup>57</sup> In this case, the ITEP Report assigns the estimated foreign income perceived to be foregone through global profit shifting to states based on the respective state's average share of gross domestic product – but fails to account for inclusion of the foreign factors in the denominator of the taxpayer's apportionment formula that would significantly dilute the apportionment percentage and thus reduce the revenue share conceptually allocated by the ITEP Report to the respective states.<sup>58</sup> Indeed, a recent study by the Tax Foundation concluded that "This is not a small error; its omission makes the entire analysis unusable."<sup>59</sup>
- **Many States Already Tax Significant Amounts of Foreign-Source Income** – The ITEP Report's allocation of "foregone" foreign-source income to various states does not account for the significant (and increasing) share of foreign-source income already subject to tax by numerous states. As Table 2 indicates (below), some states include a percentage of foreign dividends in the tax base for water's-edge filers (for example, California taxes 25% of foreign dividends), and a significant number of states now tax a percentage of federal GILTI (Global Intangible Low-Taxed Income) ranging from 5% to 50%. Three states (New Hampshire, Vermont, and Minnesota) tax at least 50% of both GILTI and foreign dividends.<sup>60</sup>

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<sup>56</sup> *Id.* at 1. "To illustrate the impact of our adjustment to resolve the issues, we offer revised estimates of the U.S. revenue lost to BEPS that are on average only one third of those found in the literature."

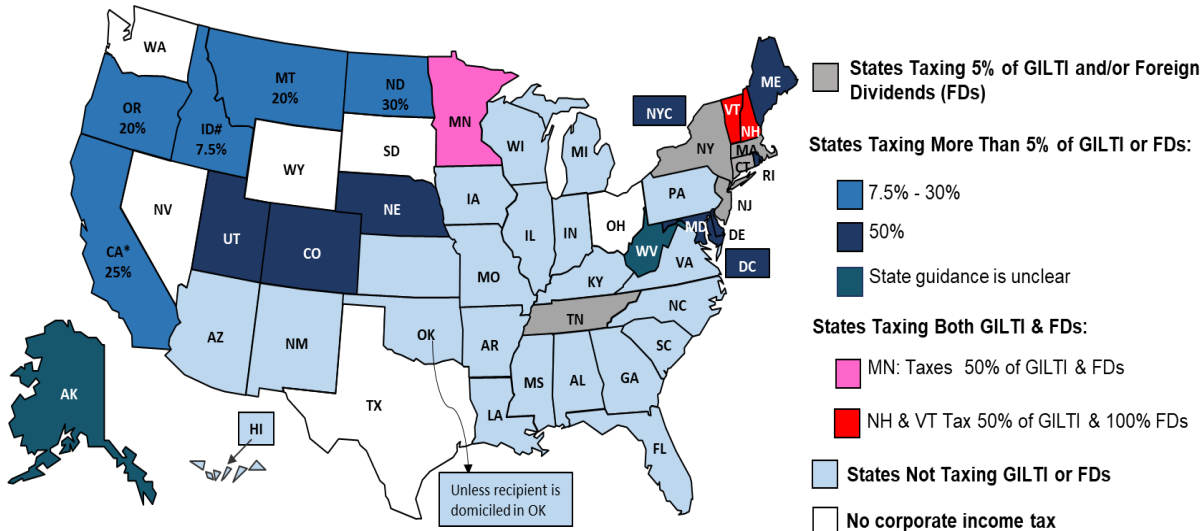
<sup>57</sup> See Karl Frieden & Joseph Donovan, *Where in the World Is Factor Representation for Foreign-Source Income?*, Council On State Taxation (COST), (April 2019), [STN 04-15-2019.book \(cost.org\)](#); Jared Walczak, *The Faulty Revenue Estimate Behind Minnesota's Consideration of Worldwide Combined Reporting*, The Tax Foundation (May 2023), [Minnesota Worldwide Combined Reporting | Tax Foundation](#).

<sup>58</sup> See Frieden and Donovan.

<sup>59</sup> See Walczak, *The Faulty Revenue Estimate Behind Minnesota's Consideration of Worldwide Combined Reporting*.

<sup>60</sup> GILTI (Global Intangible Low Taxed Income) essentially acts as a minimum tax on foreign source income.

**Table 2: State Taxation of GILTI and Foreign Dividends**



\* CA taxes 25% of foreign dividends

**Disclaimer:** This map is based on the best available information, but several states do not have clear guidance on GILTI. Therefore, this information should be used for general guidance and not relied upon for compliance.  
**Source:** Council On State Taxation (COST)  
 August 2023

- The Study Ignores State Addback Statutes** – Of the \$17 billion increase in state corporate income taxes estimated by ITEP from adopting mandatory worldwide combination, the Report suggests \$2.85 billion will come from the separate reporting states first switching to domestic combination. The rest comes from all states switching to worldwide combination. The \$2.85 billion estimate is derived from extrapolating studies on combined reporting in Maryland and Rhode Island and estimating a 20 percent increase in corporate taxes from the switch to domestic combined reporting. However, it appears the Report fails to compensate for the revenue currently paid under state addback statutes which would be redundant under a combined reporting regime. Addback statutes require an affiliated group of companies with intercompany transactions to “add back” to state income those intercompany transactions dealing with mobile (*i.e.*, easily movable) sources of income such as interest, and income from intangibles such as patents, copyrights, and trademarks. While proponents of combined reporting will suggest that the unitary combination of entities in a tax return will mitigate the need for addback statutes, the revenue derived therefrom will nevertheless be eliminated if separate filing states enact combined unitary reporting, and thus their elimination should be acknowledged and tallied in any meaningful revenue estimate.
- Not All or Even Most Foreign Income is “Displaced Domestic Income”** – It has been well documented that the complexities of the global economy and the realities of multinational tax planning result in a certain amount of corporate profit shifting and base erosion. But as noted, the level of this profit-shifting activity is very difficult to measure. Inevitably, estimates of base erosion are conflated with the actual (and legitimate) foreign operations of U.S. multinationals. As noted in COST’s recent article on the State Taxation of GILTI, the argument that most or all foreign income earned by U.S.

multinationals is really “displaced domestic income” is “a startling over-generalization.” In 2018, the companies within the S&P composite index (over 95% based in the United States) had aggregate sales of \$11.35 trillion, of which 42.9% – or about \$4.87 trillion – were foreign sales. The notion that much (or for some companies “all”) of the income earned from these foreign sales should be taxed by the states because the income is somehow “displaced domestic income” is disconnected from the realities of global commerce.<sup>61</sup>

### **C. The ITEP Report Is Outdated and Does Not Reflect the Impact of Global Tax Reform**

Because the ITEP study was released in 2019, it does not, nor cannot, address the reductions in global profit shifting attributable to the 2024 implementation of the OECD/G20’s Pillar 2 international tax reforms. As discussed above, the implementation of the global minimum tax under the OECD/G20’s Pillar Two tax reform will significantly reduce the level of and incentive for profit shifting, narrowing even further the so-called category of “displaced domestic income.” And as noted in Part III C., *infra*, enactment of the Tax Cuts and Jobs Act in 2018, particularly the rate reduction from 35 percent to 21 percent, significantly reduced the incentive to, and the benefit of, designing and implementing profit shifting schemes by MNEs. Because the first tax returns by impacted MNEs were barely filed when the ITEP Report was released, it also does not take into account the impact of the TCJA on reducing profit shifting out of the United States.

## **V. Practical Problems in the Implementation of Worldwide Combined Reporting**

Objections to worldwide combined reporting are focused both on the policy considerations previously discussed as well as practical considerations surrounding its implementation. The worldwide combined reporting method dictates that the apportionable tax base must include the income of all unitary affiliates without regard to geographic boundaries or business organization structure. In theory, the worldwide combined reporting tax scheme appears simple. However, in practice, implementing a worldwide combined reporting tax scheme is extremely complex and burdensome for both taxpayers and tax administrators.<sup>62</sup>

### **A. Defining the Composition of the Unitary Group**

The objective of the worldwide combined reporting method is to treat all members of a unitary business group as a single entity. This is accomplished by requiring a taxpayer to include the income and apportionment factors of unitary affiliated entities when calculating its share of the unitary business income subject to tax. The first step in achieving that objective is determining the composition of the

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<sup>61</sup> Karl A. Frieden & Erica S. Kenney, *Eureka Not! California CIT Reform Is Ill-Conceived, Punitive, and Mistimed*, *Tax Notes State* (May 24, 2021) at 808-812, [TNS 05-24-2021.book \(cost.org\)](https://www.courtlistener.com/doc/1/21/tns-05-24-2021-book/cost.org/).

<sup>62</sup> The administrative issues discussed in this section are based upon discussions with taxpayers that currently file tax returns on a worldwide combined reporting basis.

unitary business group, which requires a “unitary analysis” for each member of the affiliated group.<sup>63</sup> Such an analysis, as the unitary cases show, is quite complex even at the domestic level. Extending the analysis to foreign entities enhances that complexity. First, it requires an understanding of foreign governance and entity formation rules. As with any unitary analysis, documentation is required to establish the existence or nonexistence of a flow of value, functional integration, centralized management, or economies of scale. The requisite supporting documentation may not be kept in the ordinary course of business by foreign affiliates, or if kept, it may not be in English. An affiliated group with a foreign parent only adds to the difficulty of obtaining the necessary information and the burden of the analysis.<sup>64</sup>

Adding to the complexity of determining the composition of the unitary group is the fact that states may, for various policy reasons, choose to statutorily exclude otherwise unitary members from the unitary business group. For example, state statutes often exclude members from the unitary group that are required by statute to use a special industry apportionment formula, or, in the case of insurance corporations or financial corporations, are subject to a different type of tax on the entity. States may also decide for reasons of policy or administrative ease to exclude entities in the group which operate as pass-through entities. In several states, pass-through entities (including but not limited to partnerships, S corporations, and limited liability companies) are not taxed as corporations and are not themselves members of the unitary combined group.

Although the pass-through entity is not taxed at the entity level, the unitary group's share of the pass-through entity's income and apportionment factors are included in the group's income and apportionment factors. Such statutes require an additional layer of analysis to determine initially if a foreign entity not only is unitary but also to determine if that entity would be characterized as a pass-through entity for state income tax purposes.<sup>65</sup> Depending on the results of the analysis, the next step is to compute the amount of pass-through income and related apportionment factors. Conversely, several states characterize pass-through entities as separate entities and tax those entities as if they were a corporation. Again, a fundamental understanding of the respective foreign governance rules is necessary to classify the foreign entity. Upon establishing the classification of the entity, a reversal of the flow-through income and apportionment factors may be required to avoid double taxation.

## **B. Computation of Worldwide Apportionable Income**

Establishing the composition of the unitary group is only the first step in implementing a worldwide combined reporting system. Step two is computing the worldwide apportionable income tax base. In

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<sup>63</sup> Multinational affiliated groups can often contain several hundred entities.

<sup>64</sup> We can only speculate as to the foreign parent's reaction when an auditor from a state shows up on their doorstep and asks to see all the parent company's books and records as part of a state audit of an affiliated group's global income.

<sup>65</sup> The layers of complexity increase if the pass-through entity is not 100% owned by the affiliated group. In such instances the cooperation of the other owners is required.

general, the starting point for state corporate income is federal taxable income.<sup>66</sup> Foreign entities are not required to and do not compute federal taxable income. Thus, to comply with a worldwide combined reporting system, foreign entities would be required to compute pro-forma U.S. federal taxable income. The logical starting point for the computation, of course, is financial accounting (book) income. Although logical as a starting point, its use raises several issues. First, different financial accounting methods may be utilized by individual members of the same unitary group, e.g., GAAP v. IFRS.<sup>67</sup> A multinational group with a foreign parent is required to use IFRS. Adding to the compliance burden is the fact that numerous differences exist between federal tax accounting principles and financial accounting principles. Such differences must be accounted for to reach a reasonable approximation of federal taxable income. Accordingly, adjustments are required for each member's book income. For example, adjustments are required for differing book versus tax depreciation methods, numerous timing differences, and currency exchange rates.<sup>68</sup> Any failure to adjust financial statement income of the foreign affiliates results in a mismatch of income reported for state corporate income tax purposes – domestic unitary members are reporting apportionable taxable income on a federal taxable income basis and foreign members are reporting on a book income basis. The result is an apples-to-oranges approach to computing unitary apportionable business income. Additionally, any state-specific modifications, such as addition and subtraction modifications and adjustments related to decoupling from the Internal Revenue Code, must also be layered on to the adjustments made to foreign book income.

The compliance burden becomes heavier when other federal tax concepts are considered. Federal consolidated return concepts require the deferral of intercompany gains and losses. If the state adopts the federal consolidated return concept of deferral, the gains will not be recognized until a triggering event occurs, e.g., when the transferee leaves the combined group.<sup>69</sup> For the domestic members of the unitary group this information is available from the federal return documentation. However, for foreign entities there is no requirement to defer gains. Thus, if assets are sold between foreign group members or between a domestic member and a foreign member, an adjustment would be required to reflect the transaction.<sup>70</sup> While the focus of the burden is typically on adjustments required by foreign members of the unitary group, numerous adjustments to domestic members' federal taxable income are also required. To avoid double taxation, domestic members would need to adjust for any foreign source income or GILTI that was included in federal taxable income. Failure to allow such adjustments results in double taxation of that income.<sup>71</sup>

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<sup>66</sup> The starting point may be Federal Form 1120 line 28 (Federal Taxable Income Before Special Deductions), or line 30.

<sup>67</sup> Generally Accepted Accounting Principles ("GAAP"); International Financial Reporting Standards ("IFRS")

<sup>68</sup> GAAP requires the use of an average for currency exchanges. This is not consistent with other financial accounting methods.

<sup>69</sup> *Deferred Intercompany Stock Account (DISA) and Capital Gains Information*, Cal. Franch. Tax Bd., [2018 Instructions for Form 3726 | FTB.ca.gov](#).

<sup>70</sup> Adjustments to the basis of the assets that were sold may also be required.

<sup>71</sup> It is important to note that at the federal level a credit is provided for foreign taxes paid (the "foreign tax credit"). The purpose of the credit is to avoid double taxation of foreign income. The majority of states do not allow the credit or a deduction for foreign taxes paid, thereby ensuring double taxation of such income at the state level.

Determining worldwide unitary business income requires an additional policy decision: whether to treat members of the unitary business group as a single entity or as a collection of separate entities.<sup>72</sup> This characterization is important in determining the calculation and allocation of tax attributes, such as credits and net operating losses, as well as determining which member is ultimately liable for the tax. Net operating losses pose significant challenges in a domestic combined reporting tax calculation and are magnified in a worldwide combined reporting tax scheme. The initial question is whether a combined net operating loss incurred in one year can be carried over to a subsequent tax year and used to offset the entire unitary group's combined income. Alternatively, each member has its own net operating losses to utilize against its portion of the unitary business income. The latter approach is extremely burdensome as it requires each member of a unitary group to track its individual losses. Similarly, questions arise as to how losses incurred prior to joining a unitary group may be utilized, *i.e.*, pre-worldwide combined reporting, or what, if any, portion of a loss is attributed to a unitary member who leaves the group. Credits also pose difficult issues. Can credits earned by one member be used to offset the income of the entire group? The issues raised with respect to the use of losses apply equally to the use and allocation of credits.

### C. Applying the State Apportionment Formula Across International Borders

The third step is to apportion worldwide unitary business income. For purposes of apportioning income, most states have moved from an equally weighted three-factor formula to a single sales factor formula. The tax base computational issues incurred by the foreign entities extend to the computation of the unitary group's apportionment factors. Initially, the foreign entities' gross receipts must be converted to U.S. dollars, raising issues of timing, inflationary differences among countries, and exchange rate differentials. The determination of how the worldwide unitary group is characterized also has a significant impact on the group's apportionment computation. The determination of whether the members of the unitary business group are viewed as separate entities or as a single entity is a key factor for purposes of apportioning income.<sup>73</sup>

In states employing the separate-entity approach for apportionment purposes, sometimes referred to as the *Joyce* rule<sup>74</sup>, the determination of the computation of the unitary group's sales factor numerator is made on an entity-by-entity basis. Only those unitary business group members which themselves have nexus in the taxing state will include their receipts in the numerator of the unitary group's sales factor. To accurately compute the numerator of the sales factor, a nexus analysis for all entities in the group (often numbering in the hundreds) may be required due to the adoption of economic nexus principles by most

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<sup>72</sup> See *In re the Appeal of Joyce, Inc.*, No. 66-SBE-070 (Cal. State Bd. Of Equalization Nov. 23, 1966), see also *In re the Appeal of Finnigan Corp.*, No. 88-SBE-022 (Cal. State Bd. Of Equalization Aug. 25, 1988).

<sup>73</sup> A state's approach to the treatment of apportioning income of the unitary group may not be consistent with its policy for calculating and allocating tax attributes or determining who bears the ultimate tax liability. A state may adopt the single entity approach solely for purposes of apportionment but may view the members as separate entities when it comes to determining and utilizing tax attributes or determining tax liability.

<sup>74</sup> See *In re the Appeal of Joyce, Inc.*, No. 66-SBE-070 (Cal. State Bd. Of Equalization Nov. 23, 1966).

states. For states adopting the single-entity approach for apportionment, sometimes referred to as the *Finnigan* rule,<sup>75</sup> unitary entities are combined for purposes of computing the numerator of the sales factor. Thus, sales of individual unitary group members into the taxing jurisdiction who do not have nexus with the taxing jurisdiction will be included in the computation of the receipts factor numerator. Additionally, questions are raised with respect to application of the P.L. 86-272 safe-harbor provisions to foreign entities.<sup>76</sup> Computation of “throwback sales” under state throwback statutes will differ depending on whether the state has adopted *Joyce* or *Finnigan* and adheres consistently to the underlying principles of each method.<sup>77</sup> Finally, the state trend towards adoption of market-based sourcing rules in the apportionment formula and the lack uniformity in the application of those rules adds yet another layer of complexity in computing a worldwide apportionment percentage.

#### **D. Domestic and Foreign Administrative Issues**

For federal tax purposes the parent company generally acts as the agent for the entire consolidated return group. For combined reporting purposes a parent corporation generally does not act as the agent for the group. Rather, each individual member of the unitary group is legally responsible for filing its own return and for its own tax liability. An exception to the general rule applies if the members elect to file a single combined return on behalf of the entire group. A fundamental question then arises: Does each member need to individually make and file the election for a worldwide return? A requirement that each member must individually consent to combined filing raises significant compliance burdens when seeking consent of foreign members. In many foreign countries, technology secrets, foreign relations, and government ownership questions may be implicated. Additionally, the election to file a single return may not in all cases bind the members for other substantive elections, e.g., those concerning accounting methods. Compliance burdens are compounded if each foreign member must evaluate and make its own substantive elections. If the parent company does not act as the agent of the unitary group, other administrative issues arise with respect to the ability to sign returns, execute statute of limitations waivers, and grant powers of attorney.

#### **E. Audit Burdens on Taxpayers and Tax Administrators**

Administrative burdens resulting from adoption of a worldwide combined reporting tax scheme are not only borne by the taxpayer. If such a tax scheme is adopted, state tax administrators will be required to retool their revenue departments. The first step in a unitary audit is to verify the composition of the unitary business group. To evaluate the composition of the worldwide unitary group, auditors will be required to understand and evaluate relationships between various foreign and domestic members of the group. This

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<sup>75</sup> See *In re the Appeal of Finnigan Corp.*, No. 88-SBE-022 (Cal. State Bd. Of Equalization Aug. 25, 1988).

<sup>76</sup> 15 U.S.C. §§ 381-384 applies only to domestic entities. Several states have extended the safe harbor rules to foreign entities. However, there is no uniform approach to the application.

<sup>77</sup> Throwback sales occur when a member of the group sells into a state in which it has no nexus. If a state has enacted a throwback rule, such non-nexus sales are “thrown back” to the taxing jurisdiction for inclusion in the numerator of the apportionment fraction. Under *Finnigan*, all members have nexus in every state in which one of the members has nexus, so throwback is reduced. Under *Joyce*, nexus is calculated on a separate entity basis. The same dichotomy exists for determining protections under 15 U.S.C. §§ 381-384.



requires additional documentation review and a thorough understanding of foreign governance rules for entity structure – what is considered a pass-through entity in a foreign jurisdiction and what is the equivalent of a corporation. The second step is to verify worldwide apportionable income. To audit the computation of apportionable income auditors will be required to understand foreign financial accounting rules, the interaction of those rules with federal tax accounting rules and the taxpayer’s application of the rules in computing *pro forma* federal taxable income. Unlike at the federal tax level, states do not allow a credit for taxes paid to foreign jurisdictions. In fact, most states disallow a deduction for taxes imposed on net income. To determine what foreign taxes may be deducted in arriving at apportionable income, auditors will be required to understand foreign tax structures, including which foreign taxes are characterized as an income tax, gross receipts tax, a privilege tax, value added tax, or a dual capacity tax. Finally, the timeline for completing an audit is likely to be extended due to the amount and complexity of information required to be reviewed to complete a worldwide unitary audit.

#### **F. The Complexity of Worldwide Combined Reporting Should Not be Discounted.**

Proponents of worldwide combined reporting consistently discount the complexity of filing a worldwide combined report by noting that several multinational entities have elected to file on that basis.<sup>78</sup> The fact that multinational entities have chosen to file or in some cases are mandated to file on a worldwide basis does not lessen the complexities in complying with that tax scheme. What proponents fail to acknowledge with their one-size-fits-all platitude is that entities electing to file on a worldwide basis have analyzed the financial impact of that method and have concluded that the financial benefits outweigh the complexities and administrative burdens of compliance.

The proponents of mandatory worldwide combined reporting are also quick to point out that states implementing the reporting method during the 1980s were willing to accept “reasonable approximations” for calculating the income of foreign subsidiaries for the report, and that such approximations are “still used!” by taxpayers electing to file on a worldwide combined basis.<sup>79</sup> However, what the proponents fail to state is that the “reasonable approximations” may only be acceptable in appropriate cases.<sup>80</sup> When or what is an “appropriate case” that warrants reasonable approximations is ill-defined or not defined at all. As a result, on audit, taxpayers and tax administrators are faced with the fundamental issue: will reasonable approximations be accepted, and if accepted, what is reasonable? Many of the fundamental issues discussed in this section may only be reconciled through a series of negotiations between tax administrators and the taxpayer. The result is a negotiated give-and-take that ultimately leads to an approximation that both parties can live with. The interesting aspect of this compliance hurdle is that the negotiated solutions to achieve reasonable approximations may differ, not only from audit cycle to audit cycle, but from taxpayer to taxpayer, depending on software systems, company structures, and the

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<sup>78</sup> Darien Shanske, Professor, UC Davis School of Law, PowerPoint Presentation before the New Hampshire Commission on Worldwide Combined Reporting for Unitary Business under the Business Profits Tax (Sep. 25, 2023).

<sup>79</sup> *Id.* at slide 19.

<sup>80</sup> See *Barclays* at 314.

availability of foreign financial and tax information. The reality of the compliance burden is such that “reasonable approximations” may only add to the complexity of a worldwide combined reporting tax scheme rather than simplify it, as proponents suggest. There can be little doubt, however, that state departments of revenue will more zealously pursue audits of a mandatory imposition of the filing method than they will against taxpayers negotiating return positions under an elective alternative filing method.

## **VI. Conclusion**

Mandatory worldwide unitary combined reporting is not a new idea. It was tried and abandoned over forty years ago in the face of threats of retaliatory taxation by our trading partners, the real potential for double taxation, and its complex and often irreconcilable compliance burdens. Why are we seeing its resurgence? Over the last twenty years, many countries lowered their corporate income tax rates to incentivize businesses to locate and expand therein. As the disparity between corporate tax rates imposed by various countries grew, policymakers at the international level became concerned with the increased use of global profit shifting – the artificial shifting of income and activity from high-tax jurisdictions to low-tax jurisdictions. International collaborative efforts to combat such profit shifting have been underway at the OECD for many years, resulting in its 2015 BEPS Project recommending methods to address international “base erosion and profit shifting,” and continuing through its Pillar 2 recommendations for a global alternative minimum tax. Despite the success and promise of the OECD project, certain state academics and commentators are urging states to unilaterally recoup revenues allegedly lost to global profit shifting by implementing mandatory worldwide combined reporting. It is significant that the current OECD Pillar 1 and 2 proposals for reforming international taxation steer clear of any consideration of mandatory worldwide combined filing. Additionally, the United States government, which adopted sweeping tax reform with the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, moved away from its prior worldwide tax filing regime to a quasi-territorial tax system that includes a form of a global minimum tax on foreign source income principally through the inclusion in the corporate tax base of 50 percent of global intangible low-taxed income (GILTI).

To many of the proponents of mandatory worldwide combined reporting, the simplicity and elegance of applying a mathematical formula at the state level to resolve issues of transfer pricing is seen as a practical and effective solution to the problem of global profit shifting. Unfortunately, the issues unearthed during the initial experiment with state use of mandatory worldwide combined reporting in the 1980s are still very much present and problematic. As noted, these range from the political (potentially significant objections from the Executive Branch and many of our international trading partners) to the practical (significant compliance difficulties for taxpayers subject to the regime, and audit difficulties for departments of revenue seeking to audit foreign-based entities). And if states choose to pursue the filing methodology, they will be doing so at a time when the international tax community, through the OECD, is making real headway on a global solution to profit shifting through reduced rate disparities by countries,

imposition of an international minimum tax, and other unilateral steps taken by the U.S. Government. The continued OECD progress in this area highlights the importance of resolving this issue on a global basis, and not through unilateral actions at the subnational level by states. Individual state enactment of mandatory worldwide reporting seriously risks the opprobrium of our international trading partners and could jeopardize economic development opportunities through direct foreign investment, in return for uncertain and declining revenues. Indeed, to many international companies seeking to invest in the United States, adoption of mandatory worldwide combined reporting sends up a warning flag that the State is a hostile environment for business expansion and relocation. The 1980s brought us many memorable but regrettable innovations, including VCRs, mullets, and parachute pants. Like mandatory worldwide combined reporting, the shelf-life of most of these innovations was mercifully short and are best left in the '80s, where they belong.<sup>81</sup>

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## APPENDIX: Origins of the Unitary Theory of Apportionment

Historically, two basic methods were used for attributing income to a taxing state: separate geographic accounting and formulary apportionment.<sup>82</sup> The separate accounting method was founded on the premise that income is taxed based on the business activities that are within the state's geographic boundaries. Under this method, the corporate activities within a state are considered separate and distinct from those activities outside the state.<sup>83</sup> Formulary apportionment rejects geographical boundaries as a determinant based on the theory that business activities within a state are so intertwined with business activities outside the state that it is not possible to separately quantify the income attributable to each state in which business is transacted.<sup>84</sup>

The use of formulary apportionment resolves some of the difficulties in dividing the income of a multistate/multinational corporation with integrated and interdependent operations by providing a rough approximation of the corporation's income attributable to the operations within the state.<sup>85</sup> The unitary business principle is the foundation for the formulary apportionment concept – its application is the “linchpin” that establishes a rational relationship between the taxing jurisdiction and the income sought to be taxed.<sup>86</sup>

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<sup>81</sup> See Jared Walczak, *Leave Worldwide Combined Reporting in the '80s Where It Belongs*, The Tax Foundation, (September 2023).

<sup>82</sup> Prior to Pillar 2, separate geographic accounting was the method used by most countries. With the adoption of Pillar 2, many countries are now moving away from this practice for the purpose of calculating a global minimum tax.

<sup>83</sup> Each item of revenue and expense is sourced to the state in which it was generated.

<sup>84</sup> Formulary apportionment is grounded in the Uniform Division of Income for Tax Purposes Act (UDITPA).

<sup>85</sup> *In Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 792 (1992) the Court held that UDITPA counts as apportionable business income when “acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.” (citing UDITPA § 1(a), 7A U.L.A. 336).

<sup>86</sup> *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 439 (1980) (“[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle”).

## A. Evolution of the Unitary Concept - the Unit Rule

Formulary apportionment was first used to value property owned by railroads, telegraph and express companies, toll bridges, and other transportation companies for property tax purposes. Historically, property owned by these industries was separately assessed and taxed based on geographic location. The application of separate accounting was difficult because it often resulted in the undervaluation of property in some states due to the failure to take into consideration the enhancement in value that occurs when the property was included in the total business. In the late 1800's the U.S. Supreme Court in a series of property and capital stock tax cases involving railroads, telegraph, and express companies addressed whether the states could include an apportioned amount of the value of property located in other states in the tax base. The Court in these early cases sanctioned the use of the "unit rule" for determining the taxable portion of the value of the capital stock of an interstate railroad adopting the theory that the property was so interconnected it had to be included to accurately reflect values.<sup>87</sup> The Court set forth the rationale for the unit rule when it rejected the argument that the apportionment method should be confined to those cases in which there is a contiguous physical unit of the taxpayer's property in the various states holding that unity is more than mere ownership; rather, the "unit" is a unity of use and management. *Adams Express Co. v. Ohio State Auditor*.<sup>88</sup> The unit rule developed in these capital stock and property tax cases was the predecessor to the unitary business concept which is the foundation of formulary apportionment for corporate income taxes.

## B. Application of the Unit Rule to Income Tax Cases

The Supreme Court in the late 1920s, in a series of corporate income tax cases, began to sanction state application of the unit rule and the formulary apportionment concept beyond property and capital stock taxes. *Underwood Typewriter Co. v. Chamberlain*<sup>89</sup> was the first Supreme Court decision to apply formulary apportionment to a vertically integrated corporation's entire net income. The Court rejected the use of separate accounting, holding that where a business manufactures in one state and sells in another, it is extremely difficult to accurately segregate the profits by geographic location. The Court did not specifically use the term "unitary business", but the decision is clear that formulary apportionment applies when the profits of a business are earned by a series of transactions beginning with manufacturing in one state and ending with the sale in another state.

Four years later the Court again addressed the concept in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*.<sup>90</sup> Bass Ratcliff was a British company which brewed ale in England and sold it in the United States through offices in Chicago and New York. The company challenged the use by New York of a

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<sup>87</sup> See *State R.R. Tax Cases*, 92 U.S. 575 (1875); *Del. R.R. Tax*, 85 U.S. (18 Wall.) 206 (1873); and *Pittsburgh, C., C. & S. L. R. Co. v. Backus*, 154 U.S. 421 (1894). The Court sanctioned the use of an apportionment method measured by the ratio of track miles in the state to total track miles.

<sup>88</sup> *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 227 (1897) ("[T]he unit rule may be applied to express companies without disregarding any other Federal restriction.").

<sup>89</sup> In *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120 (1920), the court found nothing to indicate that the method of apportionment adopted by the state was inherently arbitrary or that it produced an unreasonable result.

<sup>90</sup> *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 284 (1924).

single factor property formula to measure net income. the Court held that statutory apportionment was not arbitrary or unreasonable. Even though in the previous year the foreign business did not yield net income from operations within New York, it was not relieved of a privilege tax thereto owed. The Court, in sustaining New York's use of the single property factor formula, held the company carried on a unitary business of manufacturing and selling ale in which the profits were earned by a series of transactions beginning with the manufacture of the ale in England and ending with the sale in New York. The manufacturing portion of the business alone did not produce the profits; the sales component of the business also contributed to the profits of the company. Therefore, the state was justified in attributing to New York a just proportion of the total profits.

The early 20th century income tax decisions refined the “unit” concept, concluding that before a formula may be applied to apportion the income of a multijurisdictional business comprising numerous entities, a determination must be made that the divisions, branches, or members of that controlled group constitute a unitary business. All these early decisions turned on the existence of a close economic interrelationship between the operations in the various states, *e.g.*, with either an inter-branch or intercompany flow of product. The Court in its early decisions considered problems of formulary apportionment in situations in which the unitary nature of the enterprise was clearly established. The holdings of these cases illustrate the Court's often stated reason for formulary apportionment; *i.e.*, when the operations in various states are sufficiently interrelated and integrated, they should be treated as a single unit for corporate income tax apportionment purposes.

### C. Constitutional Challenges to the Unitary Concept

The Due Process analysis was the focus of the Court's initial determination of the existence of a unitary business. *Mobil Oil Corporation v. Commissioner of Taxes*<sup>91</sup> was the first of a series of decisions under the Due Process Clause to delineate the parameters of a unitary business for state income tax apportionment purposes. Mobil Oil challenged the inclusion of dividends in the Vermont tax base, arguing: (1) there was no nexus because the management and operation of the subsidiaries did not take place in Vermont; (2) multiple taxation would result because the dividends were subject to tax in the corporation's commercial domicile; and (3) the taxation of the foreign dividends by Vermont created an impermissible risk of multiple taxation at the international level. The Court, in rejecting Mobil Oil's arguments, held the “linchpin of apportionability in the field of state income taxation is the unitary business principle.”<sup>92</sup> The Court noted that one must look to the underlying activity, not the form of the investment, to determine the propriety of apportioning the income. If dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, the dividends are income to the

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<sup>91</sup> In *Mobil*, 445 U.S. 425 at 441, the Court stated, “[t]ransforming [its] income into dividends from legally separate entities [does not] change [the] underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.”

<sup>92</sup> *Mobil*, 445 U.S. at 439.

parent earned in a unitary business.<sup>93</sup> The principal dividend payors were part of Mobil Oil's integrated oil business and were assumed to be unitary in nature. The Due Process Clause did not limit the taxation of such dividends. The Court also reaffirmed the use of formulary apportionment, concluding that accounting for income on a geographic basis fails to account for contributions to income resulting from functional integration, centralized management, and economies of scale.

The definition of a unitary business was further refined by the Court in *Exxon Corporation v. Department of Revenue*.<sup>94</sup> The Court addressed the question of whether apportionable income may include profits from activities of a vertically integrated petroleum company when the activities were conducted wholly outside the state. The issue was answered in the affirmative as the Court held the activities within Wisconsin were part of Exxon's unitary business.<sup>95</sup> Neither the *Mobil Oil* nor *Exxon* decisions developed a specific definition of a "unitary business." Rather, the Court, in reaching its conclusion, as in its earlier decisions, relied heavily upon the facts presented to establish the existence of a highly integrated business. The Court, however, warned state taxing authorities that if the corporate activities generating the income are unrelated to the corporation's activity within the taxing jurisdiction, the Due Process Clause may very well preclude the inclusion of income in the apportionable tax base.<sup>96</sup>

The Court appeared to be developing a unitary definition based on three criteria: (1) functional integration; (2) centralized management; and (3) economies of scale. However, in *Container Corporation of America v. Franchise Tax Board*,<sup>97</sup> the Court did not, as anticipated, continue to build on the existing definition of the unitary concept. Rather, the Court set out the standard for reviewing a "unitary business" determination. The Court concluded that its "task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment'."<sup>98</sup> The Court indicated that "flow of value" rather than flow of goods is the test and decentralization of management is not enough to overcome a unitary finding. Applying this analysis, the Court upheld California's application of the unitary principles to Container's foreign subsidiaries.

Several issues remained unresolved after the *Container* decision. Container was a domestic parent corporation with foreign affiliates, and the Court reserved the question of whether the unity doctrine could be applied to a foreign parent without violating constitutional standards.<sup>99</sup> Eleven years after the *Container* decision, the Court held, in *Barclay's Bank PLC v. Franchise Tax Board*,<sup>100</sup> that the unitary

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<sup>93</sup> Mobil Oil was an integrated oil company commercially domiciled in New York. It derived a substantial portion of its income from subsidiary dividends.

<sup>94</sup> In *Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207 (1980), the Court held that Exxon's marketing operations were an "integral part of a unitary business" (at 225) and failed to show its functional departments were "discrete business enterprises" (at 224).

<sup>95</sup> The basis of the Court's conclusion was the provision of essential services, including coordinating of refining and operating functions, the existence of centralized purchasing, negotiation of exchange agreements, use of a uniform credit card system, brand names and promotional developments.

<sup>96</sup> *Mobil*, 445 U.S. at 438-442.

<sup>97</sup> *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 139 (1983).

<sup>98</sup> *Id.* at 176.

<sup>99</sup> The use of the worldwide taxation concept in a property tax context had previously been challenged as a violation of the Foreign Commerce Clause. The Court, in *Japan Line v. County of Los Angeles*,<sup>99</sup> set forth the test for determining when a tax will violate the Foreign Commerce Clause. The test incorporated the four prongs of the test set forth in *Complete Auto Transit v. Brady*<sup>99</sup> and added two additional prongs: (1) does the tax, notwithstanding apportionment, create a substantial risk of international multiple taxation; and (2) does the imposition of the tax prohibit the Federal Government from speaking with one voice when regulating commercial relations with foreign governments.

<sup>100</sup> *Barclays Bank Plc v. Franchise Tax Bd.*, 512 U.S. 298 (1994); (its companion case was *Colgate-Palmolive Co. v. FTB.*).

principle could properly be applied to a foreign parent.<sup>101</sup> The Court held the worldwide taxing method complied with the four-part *Complete Auto Transit* test.<sup>102</sup> The Court, addressing the additional foreign commerce clause prongs concluded that multiple taxation of the foreign owned group's income arising out of the juxtaposition of the two separate tax systems was not inevitable, and requiring the state to adopt arm's-length accounting would not prevent the multiple taxation that did occur. Additionally, the Court held worldwide combined reporting did not impair federal uniformity in an area where federal uniformity was essential. Unlike the case in which taxes were found to discriminate, Congress passively indicated that a state's practices do not impair essential federal uniformity. The Court in *Barclay's* retreated from its traditional role of broadly protecting foreign commerce, stating it had no constitutional authority to make the policy judgments essential to regulating foreign commerce and foreign affairs.<sup>103</sup>

#### D. California's Influence on the Unitary Theory

The California Franchise Tax Board pioneered the use of combined reporting in the 1930s by taking an expansive view of the term "entire net income of the bank or corporation" in the State's taxing statutes to infer that a "corporate taxpayer" may encompass numerous related legal entities.<sup>104</sup> As a result, early California court decisions, starting with *Butler Brothers v. McColgan*,<sup>105</sup> set the framework for the development of the unitary business concept. Butler Brothers, an Illinois corporation located in Chicago, was engaged in the wholesale dry goods and general merchandise business and operated a distribution facility in San Francisco. California subjected to tax an apportioned share of Butler Brothers' income derived from all distribution facilities. The California courts upheld the use of separate accounting was appropriate only if the business conducted in California was truly a separate and distinct business. The unitary apportionment method was the more appropriate method for determining Butler Brothers' California income because the California activities could not be clearly separated from the non-California activities. The California court embraced the "unit rule" and focused the analysis on the value-producing qualities inherent in the business enterprise. The Supreme Court affirmed California's use of combined reporting for a unitary business and for the first time set out the three unities test – unity of ownership, unity of operations, and unity of use – which was foundational to determining the existence of a unitary business relationship. Four years later, building off the *Butler Bros.* decision, the California Supreme Court in *Edison California Stores* enunciated the contribution and dependency test for determining the

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<sup>101</sup> In *Colgate*, the California Appellate Court held that the worldwide unitary method of taxation does not violate the Foreign Commerce Clause. In so holding, the Appellate Court first analyzed the case considering the dormant Foreign Commerce Clause tests set out in the *Japan Line* decision and refined by the Court in *Container*, and concluded there was no risk of multiple taxation.

<sup>102</sup> Nexus was supplied by the presence of the taxpayers in California; the taxpayers had not challenged the fair apportionment or fair relation components of the four-part test; and the taxpayers had not demonstrated that worldwide combined reporting's compliance burdens were disproportionately imposed on foreign enterprises.

<sup>103</sup> The worldwide combination method as applied to a domestic parent corporation (which was upheld in the *Container* decision), was again the subject of a challenge in the companion case to *Barclays: Colgate-Palmolive Co. v. Franchise Tax Board*. *Colgate* was joined with *Barclay's* for oral argument at the Supreme Court. The Court, in a 9-0 decision, again upheld the use of the worldwide combined method of reporting as applied to domestic corporations.

<sup>104</sup> *California Bank and Corporation Franchise Tax Act*. 2 Gen. Laws 1937, Act 8488, p. 3851; Stat. 1929, p. 19, amended, Stat. 1931, p. 2226, Stat. 1935, p. 965, Stat. 1937, p. 2324.

<sup>105</sup> *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); aff'd. 17 Cal. 2d 664 (1941).

existence of a unitary business.<sup>106</sup> The purpose of the test was to determine if the operations of the business performed within the state contributed to or were dependent upon the operation of the business performed outside the state. Edison California Stores was one of fifteen affiliated corporations with its parent located in St. Louis. Although the business operations were not conducted by a single corporation, the California Supreme Court concluded the principle governing the allocation of income under the three-factor formula applied when the essence of the transaction of separate but related corporations was that of a unitary business. The court found all three unities as defined in *Butler Bros.* were present. In reaching its conclusion, the court stated, "[i]f the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary."<sup>107</sup> Subsequent California decisions continued to refine the use of the unitary concept.<sup>108</sup>

In the 1960s, the California courts' unitary analysis evolved from a focus on a flow of goods to stress contribution and dependency between the affiliates. Companies engaged in similar businesses were combined even though there was no finding of an intercompany flow of goods.<sup>109</sup> The California Supreme Court refined the unitary analysis and enunciated the following four principles: (1) The unitary concept could be applied for the benefit of the taxpayer as well as the taxing authority; (2) It was not requisite that the business segments perform a necessary and essential role with each other for unity to be found; if each segment's activities contribute to each other, the finding of unitary is justified; (3) Formulary apportionment is mandatory if a unitary business is found to exist; and (4) The interstate movement of goods is not required to establish a unitary relationship.<sup>110</sup>

In 1971, the Franchise Tax Board, incorporating the reasoning of the early California decisions, adopted Regulation §25120 which defined a unitary business based on three presumptions: (1) same line of business; (2) steps in a vertical process; and (3) strong centralized management. The regulation did not distinguish between a diverse business and a vertically integrated one. Thus, a question had been raised as to whether a different standard should be applied to a diverse business. In 1987, the Franchise Tax Board drafted amendments to Regulation 25120(b) to provide guidance on analyzing whether certain diverse businesses are unitary in nature. Specifically, the draft addressed the issue of the existence of a unitary business when the businesses are neither in the same general line of business or steps in a vertically integrated process and shifted emphasis from the existence of centralized management to one of operational and functional integration. On May 8, 1990, the Franchise Tax Board failed to reach a

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<sup>106</sup> *Edison Cal. Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 481 (1947) ("[I]f there is no [out-of-state operational] dependency [on in-state operations], the business within the state may be considered to be separate.").

<sup>107</sup> *Id.* at 484.

<sup>108</sup> A business will be an integral part of a unitary business if the operation of that portion of the business conducted within the state is dependent upon or contributes to the business without the state. *John Deere Plow Co. v. Franchise Tax Bd.*, 38 Cal. 2d 214 (1951). A unitary business exists where there is a functional relationship between the various businesses resulting in an integrated overall enterprise. In an early series of cases, the California State Board of Equalization focused on intercompany use or flow of goods to establish the unitary relationship. (See: *Appeal of Union Carbide and Carbon Corporation*, St. Bd. of Equal., August 19, 1957, where the manufacture of products by one affiliate for sale to another was held to satisfy the contribution and dependency tests. See also, *Appeal of Beatrice Foods Company and Meadow Gold Dairies*, St. Bd. of Equal., November 19, 1958, and *Appeal of Industrial Management Corporation*, St. Bd. of Equal., June 9, 1959.

<sup>109</sup> The California court's analysis applied the three unities test and concluded it was not necessary for each local operating activity to be unified with every other local operating activity. Rather, the focus was to determine whether the activity was an "integral" part of the business.

<sup>110</sup> *Superior Oil Co. v. Franchise Tax Bd.*, 60 Cal. 2d 406 (1963) and *Honolulu Oil Corp. v. Franchise Tax Bd.*, 60 Cal. 2d 417 (1963).



consensus as to further action on the proposed regulation, and strong centralized management remains the test.<sup>111</sup>

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<sup>111</sup> For an overview of the continuing controversy and state revenue impact of state adoption of the unitary combined reporting on a water's-edge basis, See: Robert Cline, *Understanding the Revenue and Competitive Effects of Combined Reporting*, Ernst & Young LLP (May 2008), Available at [12637\\_Newsletter\\_R1.indd \(cost.org\)](#).