Journal of Multistate Taxation and Incentives (Thomson Reuters/Tax & Accounting)
Volume 28, Number 5, August 2018

ECONOMIC DEVELOPMENT AND POLICY

Government Contributions to Capital—The Known and the Unknown

The TCJA treats governmental nonshareholder corporate contributions to capital as taxable income for the first time since the federal income tax was imposed.

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On September 7, 2017, Amazon announced it would build a second North American headquarters, saying: "We expect to invest over $5 billion in construction and grow this second headquarters to include as many as 50,000 high-paying jobs—it will be a full equal to our current campus in Seattle."[1] The company issued a request for proposals,[2] inviting candidates to describe the possible advantages sites in their area would offer, as well as any state, regional, or local incentives that might be provided. More than 200 cities[3] responded, seeking to win what some saw as a competition between the new tech economies[4] and others derided as the "Hunger Games."[5]

Less than one month later, on November 3, 2017, the IRS announced a rollout of "11 Large Business and International Compliance Campaigns." One of these was the "Economic Development Incentives Campaign." This campaign was apparently prompted by a concern that taxpayers might improperly treat certain government incentives as exempt nonshareholder capital contributions.[6] One commentator theorized that the IRS intended to challenge U.S. Supreme Court holdings that location inducements in the form of land contributions and cash grants are non-taxable nonshareholder capital contributions under IRC Section 118.[7]

A few days later, on November 13, 2017, the U.S. House of Representatives, Ways and Means Committee issued a report on its tax reform proposal. The proposal removed all government incentives and grants from the IRC Section 118 exemption for nonshareholder contributions to capital. The report notes:

"The Committee also believes that removing a special rule that applies only to certain contributions to a corporation by nonshareholders helps achieve the goal of similar treatment of similarly situated taxpayers. The Committee further believes that treating contributions to capital by nonshareholders as income to the corporation will remove a Federal tax subsidy for State and local governments to offer incentives to businesses as a way of encouraging them to locate operations in a particular jurisdiction. If taxpayers in a particular State or locality wish to provide such financial inducements to businesses, they should be able to do so, but they should bear the cost of such financial inducements without passing on a portion of those costs to all Federal taxpayers."[8]

A little over one month later, on December 22, 2017, President Trump signed into law H.R. 1, commonly known as the Tax Cuts and Jobs Act (TCJA).[9] That bill incorporated the Senate's version of the House proposal, treating governmental nonshareholder corporate contributions to capital as taxable income for the first time since the federal income tax was imposed.

The Joint Committee on Taxation estimates that the provision will increase federal revenue by $6.5 billion over the next decade.[10] This article examines how this change may affect corporate recipients of state and local incentives as well as the state and local governments themselves. In each case, it notes that there is a significant unknown. First, however, it is necessary to review the history of this issue.

The Past

Like most state tax epics, this one starts with a railroad case: *Edwards v. Cuba R.R.*, 268 U.S. 628 (1925). In *Cuba R.R.*, a New Jersey corporation owned and operated a railroad in Cuba, partially funded by subsidies from the Cuban government. The corporation excluded these subsidies from its federal tax return, but the United States contended the subsidies were taxable under the Revenue Act of 1916, which imposed an annual tax "upon the total net income received . . . from all sources by every corporation."[11] The U.S. Supreme Court, however, strictly construed the Sixteenth Amendment to the U.S. Constitution, which had granted Congress the authority to impose an *income* tax. What were the subsidies? Income? Gifts? Neither, as it turns out.

The Court had previously found such governmental inducements were not "mere gratuities." *Burke v. Southern Pacific R. R. Co.*, 234 U. S. 669, 679 (1914); *Louisville & Nashville R. R. v. United States*, 267 U. S. 395 (1925). But neither were they "income." Ultimately, the Court looked to the use or function of the subsidy, finding that:

"Neither the laws nor the contracts indicate that the money subsidies were to be used for the payment of dividends, interest or anything else properly chargeable to or payable out of earnings or income. The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment."[12]

In short, as reimbursements for capital expenditures and inducements for public benefit, the funds in question lacked the character of either income or a gift and were found to be nontaxable contributions to capital.

However, seven years later, the Supreme Court was faced with a slightly different case. It involved the federal government's agreement to give railroads a "minimum operating income" for six months after World War I when, under the Federal Possession and Control Act, the railroads were nationalized. During the period after the war, as they reprivatized, the railroads were aided via federal payment of a "minimum operating income." *Texas & Pacific Ry. v. United States,* 286 U.S. 285, 288 (1932). In *Texas & Pacific Ry.,* the Supreme Court again looked to the function of the contributed funds, and here it found them distinguishable from the subsidies in *Edwards v. Cuba R.R.*[13] The function of the minimum operating income was to make up a deficiency in income that would otherwise have accrued to the railroads for their general use to fund operations. As such, the payments were taxable income.

In later cases, the Supreme Court continued to hinge its analysis on the underlying function of the particular funds in question—and whether the contributions were contributions to the *capital* of the corporation. In particular, compare *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943) and *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), two cases that also create the foundations for the Court's thinking.

Subsequent to these decisions, Congress passed the 875-page Internal Revenue Code of 1954. It was the most comprehensive overhaul of the federal income tax system ever and included IRC Sections 118 and 362(c).[14] Section 118 provided an exclusion for contributions to the capital of a corporation, including by nonshareholders. The Senate Finance Committee report noted that this was a codification of court decisions on the issue.[15] Section 362(c) also assigned a zero basis to any contributed property and required reductions in basis for property acquired with contributed funds. Neither section, however, defined the term, "contribution to capital."

This question, once again, fell to the Supreme Court to answer. In yet another railroad case, *United States v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973) ("*CBQ"*), the Court addressed the question of what, exactly, is a "contribution to capital." In order to understand the Court's holding, one must understand the context. First, while the decision was issued in 1973, it concerned periods prior to the 1954 tax code. At that time, contributions to capital had a carryover basis under the existing tax law, presumably even when the contributions were *not* taxable income. The taxpayer in the case claimed depreciation on certain constructed assets that the government had required it to have in place and had also paid for. Despite not having to recognize any taxable income from these assets, the taxpayer argued it was entitled to depreciate them. A majority of the Court, however, ruled that the assets were not contributed to the corporation's capital and, therefore, were not depreciable by the taxpayer.

The dissent in *CBQ* suspected that the majority's ruling that the assets were not contributed to capital was motivated by the apparent anomaly of allowing depreciation where no income had been recognized. The dissent noted that, while it might seem an anomaly for the tax law to provide carryover basis for tax-exempt nonshareholder contributions to capital: "It was Congress that had created the anomaly, and it was for Congress to correct it," which it did in enacting Section 362(c).[16]

With this background, it is easier to understand the five-factor test that came out of the *CBQ* case and that is still used as a test for whether government assets are contributions *to the capital* of the taxpayer. Under that test, the contributed asset:

- must become a permanent part of the transferee's working capital structure,
- may not be compensation for the transferee's services,
- must be bargained for,
- must benefit the transferee commensurately with its value, and
- ordinarily will be used to produce additional income.

The railroad's purported assets in *CBQ* failed to meet the test since the facilities were not bargained for and would not have been constructed without the governmental funding. Nor did they contribute much in the way of income production and any profit was merely peripheral to the railroad's business. However, under the *CBQ* five-factor test, a wide variety of subsidies would count as nonshareholder contributions to capital. In recent years, the exemption for such contributions under IRC Section 118 has been applied to an assortment of incentives including cash grants, land, equipment, "public" infrastructure and improvements, reimbursements, refunds, and other similar transfers of money or property to a corporation.[17]

Of course, not every dollar of value received from the government is either income or a contribution to capital. Value can also be conveyed through tax credits, exemptions, deductions, abatements, and tax-rate reductions. These tax-related benefits do not constitute taxable income for federal tax purposes.[18] Instead, these incentives are simply a reduction (or potential reduction) in a taxpayer's outstanding state or local tax liability, and any related deductible expense for federal income tax purposes.[19]

The Present

The version of TCJA that emerged from the conference agreement left IRC Section 118 's general exclusion for contributions to capital in place but added the qualification that the term "contributions to capital" does not include: (1) any contribution in aid of construction or any other contribution as a customer or potential customer, and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

The new amendments will apply to contributions occurring after December 22, 2017 (the date of enactment). They do not, however, apply to contributions made pursuant to a master development plan that was approved by a governmental entity prior to the date of enactment. Will this qualification apply to the offers approved by the governmental entities made in response to Amazon's RFP? Would a contribution that has been offered, but not accepted, meet this qualification, or satisfy the *CBQ* test that the asset "must be bargained for"? It seems doubtful.

The District of Columbia passed a bill to clarify, on an emergency basis, what it believes qualifies as an approved master development plan.[20] The intent, as stated in a resolution to extend the related act, is "to ensure several District-supported development projects are considered part of a master development agreement so that they may continue to qualify for federal tax preference."[21]

The Future and the Unknown

We now turn to considering what these changes may mean for corporate recipients and for state and local governments.

From the corporate perspective

Assume that a state can offer one of two possible incentives to a corporation thinking of locating in the state, which are of equal value as far as the state is concerned[22]—state tax credits worth $1 million or land worth $1 million. How a particular corporation will value these two incentives will necessarily depend on a whole host of factors, including whether the corporation currently owes, or is expected to owe in the near future, state taxes to which the credits would apply and whether it currently has, or is expected to have in the near future, federal taxable income.

Still, it may appear that, all things being equal, under pre-TCJA law, the state tax credit (which has the effect of lowering a related federal deduction) would generally have been less valuable to a corporate recipient than the land, which, because it is a tax-exempt contribution to capital, would not have had an offsetting federal tax cost. It may also appear that now, under TCJA, the value of the two incentives will be roughly the same. That ignores, however, the effect of IRC Section 362(c) 's basis rules and the unknown effect of the change to IRC Section 118 on these rules.

Remember that after 1954, IRC Section 362(c) made it explicit that when a corporation receives tax-exempt assets or funds as contributions to capital, the basis of those assets or any assets acquired with those funds is zero. It would be natural to assume that if the taxpayer has to recognize income at the time of the contribution to capital, the taxpayer would also obtain an equivalent basis in the assets contributed. If so, then the elimination of the IRC Section 118 exemption creates a timing difference (albeit a potentially significant one)—so that tax is paid up front, rather than deferred until the assets are depreciated or sold.[23] The precise effects on a given corporate recipient will also vary.

However, also remember that under the *CBQ* decision the definition of "contribution to capital" was not set out in the 1954 federal statutes in either IRC Section 118 or Section 362 but was instead interpreted by the Supreme Court applying prior case law and the five-factor test. This has new importance under TCJA because, while the exemption in IRC Section 118 has changed, the basis rules of IRC Section 362(c) have not. The change in IRC Section 118 provides simply that while contributions to capital are generally exempt under subsection (a), there are exceptions. The exception we are concerned with provides that: "*For purposes of subsection (a)*, the term 'contribution to the capital of the taxpayer' does not include . . . any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such)."

This change, by its own terms, does not apply to IRC Section 362, meaning that there is, at least, a plausible argument to be made that the zero-basis requirement has also not changed. If so, then not only will governmental contributions be taxable, but if the related corporate assets are ever sold or exchanged, there will also be a second tax imposed on their value at that time, in the form of gain. Nor would the corporation otherwise get the benefit of depreciation expense if contributed funds are used to pay for depreciable assets. This is a permanent difference, rather than just a timing difference.[24]

Looking back to the example of the $1 million state tax credit and the $1 million contribution of land, then, under both pre- and post-TCJA time periods, the $1 million state tax credit's value is reduced by the tax effect of that credit, which when taken, reduces a federally deductible expense. The value of the land is also reduced, but it is unclear whether that value should be reduced only by the tax that might be paid in the year of contribution or also by the present value of the tax that will be paid if the land is ever sold or exchanged.[25] We assume that the IRS will clear this up eventually. When it does so, however, it will have to take into account not only the effect on state and local contributions, but also federal contributions that generally take the form of federal grants. That brings us to the effect of TCJA's change on the state and local governments and the question they may face of whether to decouple.

From the state and local governments' perspective

For states considering whether to decouple from TCJA's change in the taxable treatment of contributions to capital, it is critical to first understand that the change is not limited to *state and local* governmental contributions to capital but includes *any* governmental contributions. Therefore, federal taxable income should now also include federal grants, and such federal corporate contributions may be substantial.[26] In other words, while the federal government might claim that exempting state contributions to capital effectively provided a federal "subsidy" for those state contributions, the states could likewise claim that, to the extent they followed the federal treatment, they effectively provided a state "subsidy" to any federal contributions to capital.[27]

Now, to the extent states continue to follow federal treatment, those federal grants would also be subject to *state* tax, assuming they are reported correctly. Of course, the same thing is true when it comes to other states' contributions to capital. Therefore, a state that follows federal treatment will not only be including its own contributions to capital in the taxable base, but those of other states, as well.

If states are going to consider decoupling, so that they are not taxing their own contributions to capital, they ought to consider the effects of eliminating the state's tax on the contributions to capital by the federal government and other states.[28] Either way, a state cannot discriminate against interstate commerce by favoring in-state incentives over out-of-state incentives. This issue was effectively addressed by the U.S. Supreme Court in *Boston Stock Exch. v. State Tax Commission*, 429 U.S. 318 (1977). There, a New York statute imposing a transfer tax on securities transactions was amended so that transactions involving an out-of-state sale were taxed more heavily than most transactions involving a sale within the state. Although the intent was to assist the New York brokerage industry, the Supreme Court found that the tax violated the Commerce Clause because the choice of broker would not be made "solely on the basis of nontax criteria."[29] However, the Court also noted:

"Our decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. Nor do we hold that a State may not compete with other States for a share of interstate commerce; such competition lies at the heart of a free trade policy. We hold only that in the process of competition no State may discriminatorily tax the products manufactured or the business operations performed in any other State."[30]

What about a state taxing only *federal* grants, while not taxing its own or other states' contributions? Would that violate any constitutional principle? Probably. In *Davis v. Michigan Dep't of the Treasury*, 489 U.S. 803 (1989), the Supreme Court ruled that the state could not tax federal governmental employees differently than state employees. However, the Court left open the question of whether this was based entirely on constitutional doctrine or also on an applicable federal statute. The Court noted that, for a time, the famous case of *McCulloch v. Maryland* was read broadly to bar most taxation of one sovereign by another. In subsequent cases, however, the Court began to turn away from this expansive reading.

In *Helvering v. Gerhardt*, 304 U.S. 405 (1938) and *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939), the Court held that nondiscriminatory federal taxes could be imposed on state government employees. However, federal legislation passed at the same time as these cases were decided obscured the question of whether state taxation of federal employees was still barred by intergovernmental tax immunity. This legislation clarified by statute that federal employees could be subjected to nondiscriminatory state taxation, just as state government employees were being subjected to federal income taxes.

In *Davis,* the Court concluded that the statute and the constitutional doctrine in this area were co-extensive, and that the statute could be interpreted by using principles derived from the doctrine of intergovernmental tax immunity—especially as that doctrine pertains to what taxes would be discriminatory.[31] In that context, at least, the Court found that taxing federal employees differently than state employees was discriminatory.

Here, of course, there is no similar statutory law purporting to authorize states to levy only nondiscriminatory tax on some person who may have receipts from the federal government. Therefore, it is only the constitutional doctrine itself that may be at issue. Second, unlike wages, governmental contributions such as federal grants and similar state contributions may have distinguishing characteristics that would allow the states to treat them differently, taxing some federal and state grants while not taxing others. Third, corporate recipients of governmental grants or other contributions are, in some sense, one step removed from governmental employees.

The case of *U.S. v. New Mexico*, 455 U.S. 720 (1982) may be instructive. There, contractors to the U.S. Department of Energy argued that the state could not tax the receipts they received from the federal government under cost-plus contracts to manage certain governmental facilities. The U.S. Supreme Court unanimously rejected that claim, saying that the limits on the immunity doctrine are as significant as the rule itself and concluding that "immunity is not conferred simply because the tax has an effect on the United States, or even because the Federal Government shoulders the entire economic burden of the levy." [2] The Court, however, also noted: "It remains true, of course, that state taxes on contractors are constitutionally invalid if they discriminate against the Federal Government, or substantially interfere with its activities."[33] It was likely critical that New Mexico's tax would also have been imposed on similar contracts with the state government.[34]

On the other hand, there is a difference between wages or contract payments to third parties and governmental grants or contributions to capital. As Congress itself stated, it removed the exemption under IRC Section 118 in order to remove the "subsidy" for state incentives. Under that "subsidy" theory, there is a difference between taxing another's grants or incentives and taxing one's own.

What if the tables had been turned? Might Congress have retained the tax exemption for federal grants while taxing similar state and local contributions to capital? The answer to that question is less clear and may depend on an entirely different theory. Assuming the federal government can no more impose a discriminatory tax on states than the states can impose on the federal government and assuming the recipients of governmental grants or contributions fall within the protection of that rule, it would limit the ability of Congress to exempt its own grants while taxing similar contributions made by states.

However, there is another basis to argue that the federal government may not tax state contributions, especially if its aim is to change state policy with respect to such contributions, and that is the anti-commandeering principle. Expressed in its broadest terms, that principle restricts the ability of "Congress to require the States to govern according to Congress' instructions." *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 567 U.S. 519, 577 (2012).

In any case, Congress did not attempt to treat federal and state or local contributions to capital differently, and we assume that states would also take an all-or-nothing approach. But which should it be, all, or nothing? It depends on which is greater—the state's tax on its share of corporate income from contributions made by other states and the federal government, or the state's tax on its share of corporate income from its own contributions.[35]

If the former is greater, then it would make sense to follow the new IRC Section 118 rules even if it means the state would potentially have to gross up its own incentives to make up for the total tax cost paid by the recipient on that contribution. This would be one of many things to negotiate with that corporate recipient. However, if the state expected that its tax on its own state and local contributions would be greater, and if it assumes that such contributions will now have to be grossed up for the resulting tax cost, then it might make sense to decouple.

The Bottom Line

From the corporate recipient's standpoint, the change to the tax treatment of state and local governmental contributions to capital will factor into how those contributions are valued—but presumably all such contributions, regardless of the state or locality, will be similarly affected. Once the uncertainty with respect to the basis rules in IRC Section 362(c) is removed, this valuation should be fairly straightforward. Suffice it to say, the effect itself will vary from recipient to recipient, based on a host of other factors, but most of those factors will at least be known to that recipient.

From the state and local government perspective, the overall effects may be harder to ascertain. If the Joint Committee knows how much of the estimated $6.5 billion in federal revenues will be generated from tax imposed on federal grants versus state and local contributions to capital, it is not apparent and the authors have been unable to find that information. Most states may at least assume that the increase in their tax base will be greater as a result of the now-included federal governmental grants and other states' contributions, compared to the inclusion of that state's own contributions. However, it may depend on the state, and the size of the particular contribution contemplated.

There is one other unknown for states that decide it makes sense not to decouple. How will states know that the tax on federal grants and contributions is actually being enforced consistently with the tax on state and local contributions? After all, the federal government has an incentive to treat its own grants more favorably. Perhaps the states will need to have their own audit campaign, similar to the one instigated by the IRS, but aimed at proper reporting of *federal* grants.

[1] Summary of HQ2 Project, https://www.amazon.com/b?ie=UTF8&node=17044620011 (last visited Apr. 19, 2018).

[2] Amazon HQ2 RFP, https://images-na.ssl-images-amazon.com/images/G/01/Anything/test/images/usa/RFP_3._V516043504_.pdf (last visited Apr. 19, 2018).

[3] Alison Griswold*, A nearly complete list of the 238 places that bid for Amazon's next headquarters*, Quartz Media, Nov. 04, 2017, https://qz.com/1119945/a-nearly-complete-list-of-the-238-places-that-bid-for-amazons-next-headquarters/ (last visited Apr. 19, 2018).

[4] Darla Cameron and Jonathan O'Connell, *The Amazon finalists are already building tech economies. Which are the best?* The Washington Post, Mar. 7, 2018, *available at* https://www.washingtonpost.com/graphics/2018/business/amazon-hq2-tech-cities/?utm_term=.9644e8f6ec06.

[5] *See* Fran Spielman, *Protesters decry 'Hunger Games' competition for Amazon's HQ2*, Chicago Sun Times, Apr. 10, 2018, *available at* https://chicago.suntimes.com/news/protesters-decry-hunger-games-competition-for-amazons-hq2/ (last visited Apr. 19, 2018).

[6] *Available at* https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns-0 (last visited Apr. 19, 2018).

[7] *IRS Expands Audit Campaigns to Include Economic Development Incentives,* Crowell Moring newsletter, Nov. 8, 2017, https://www.crowell.com/NewsEvents/AlertsNewsletters/all/IRS-Expands-Audit-Campaigns-to-Include-Economic-Development-Incentives (last visited Apr. 19, 2018).

[8] Report of the Committee on Ways and Means, House of Representatives, on H.R. 1, Tax Cuts and Jobs Act, p. 256, Nov. 13, 2017, *available at* https://www.congress.gov/115/crpt/hrpt409/CRPT-115hrpt409.pdf (last visited Apr. 19, 2018).

[9] Pub. L. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

[10] https://waysandmeansforms.house.gov/uploadedfiles/12.15.17_jct_score.pdf at 6.

[11] 268 U.S. at 631.

[12] *Id.* at 633.

[13] 286 U.S. at 290.

[14] *Important Dates in U.S. History,* CCH Chart, https://www.cchgroup.com/media/wk/taa/pdfs/news-and-insights/wbot/important-dates-in-us-history-chart.pdf (last visited Apr. 2, 2018).

[15] Senate Finance Committee Report on Internal Revenue Code of 1954, S. Rep. No. 1622 (1954).

[16] 412 U.S. at 426.

[17] Timothy A. Gustafson and Hanish S. Patel, *Many State Tax Incentives Are Now Taxable Due to Federal Tax Reform*, BNA Daily Tax Report, Jan. 8, 2018, https://www.bna.com/state-tax-incentives-n73014473881/ (last visited Apr. 7, 2018).

[18] *Id.*

[19] IRS Issue Paper LMSB-04-0408-023, https://www.irs.gov/pub/irs-wd/1147024.pdf (last visited Apr. 19, 2018).

[20] D.C. Act 22-636 (passed Dec. 29, 2017), http://lims.dccouncil.us/Download/39463/B22-0636-Introduction.pdf.

[21] http://www.dccouncil.us/files/user_uploads/event_testimony/3_1_18%20Master%20Development%20CRE%20Dec.docx (last visited Apr. 12, 2018).

[22] It may very well be that the state does *not* value these two incentives the same. It may be that the state believes the productive use of the land will have other economic benefits. In this article, however, when it comes to particular incentives offered to particular taxpayers, we consider them from the standpoint of the corporate recipient.

[23] Obviously, time matters. So even a timing difference that tends to turn deferred taxes into current taxes will impose a real cost because of the time value of money.

[24] Again, time matters, as discussed in the preceding note.

[25] Depreciable assets raise similar issues beyond the scope of this article.

[26] For a list of federal grant programs see Philip Mattera and Kasia Tarczynska, *Uncle Sam's Favorite Corporations,* Good Jobs First, Mar. 2015, p. 14-16, *available at* http://www.goodjobsfirst.org/sites/default/files/docs/pdf/UncleSamsFavoriteCorporations.pdf.

[27] As the quotations around the word "subsidy" indicates, these are not true subsidies. It is not as though the federal government is giving money to the states to be used for contributions, or that the states are giving money to the federal government to be used for federal grants. The question is how the recipient values these contributions.

[28] Georgia recently updated its IRC conformity date to Feb. 9, 2018, but will treat IRC Section 118 as it was in effect before the 2017 enactment of TCJA. *See* Ga. Act 284 (H.B. 918), Laws 2018.

[29] 429 U.S. at 331.

[30] 429 U.S. at 336-37.

[31] 489 U.S. at 811-814.

[32] 455 U.S. at 733.

[33] *Id.* at 744.

[34] *Id.* at 727.

[35] Items of income of a multistate corporation must generally be apportioned if they are unitary.