State Responses to Tax Planning By Multinational Corporations

by James W. Wetzler

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Wetzler discusses state policy options to address base erosion and profit shifting by multinational corporations and concludes that each of those options has its own set of issues.

Base erosion and profit shifting by multinational corporations (MNCs) has become an international scandal. What, if anything, should states do about it?

States' concern about BEPS arises because it erodes their corporate income tax bases. Even though corporate income tax revenues amounted to only 3.6 percent of overall state and local tax revenues in 2011, many state policymakers (rightly or wrongly) perceive taxes on corporations as largely burdening residents of other jurisdictions and, therefore, as attractive to their constituents. Several state policy options to combat BEPS are addressed in this paper. As will be seen, none are entirely satisfactory.

I. Scope of the Problem

Statistical measures suggest that states experience significant revenue loss from BEPS. A crude estimate of the scope of the problem can be made with data from corporate tax returns.[1] In 2010 C corporations filing Form 1120 reported a gross margin (income subject to tax divided by gross receipts) of 5.2 percent. Of that group, which essentially represents the existing population of state corporate taxpayers, the U.S.-owned corporations earned a gross margin of 5.9 percent, while foreign-owned corporations (inbound investors) reported a gross margin of only 3.1 percent. Controlled foreign corporations of U.S. parents, whose income is generally not part of the existing state tax base, reported a gross margin (net income before taxes divided by gross receipts) of 13.3 percent.[2] Thus, CFCs collectively appear to be more than twice as profitable as their U.S. affiliates, while inbound investors appear to be almost 50 percent less profitable than the U.S.-owned domestic corporations with which they compete.

The disparities in apparent profitability between CFCs and their U.S. affiliates become even more pronounced when one considers the CFCs' country of incorporation. Approximately two-thirds of CFC pretax profits are derived from corporations incorporated in countries that could be labeled tax havens, and in those cases, gross margin swells to 17.2 percent, compared with the gross margin of 9.1 percent for the rest of the CFC population.[3]

Those rough numbers are not adjusted for things such as industry mix and other business differences that affect true profitability, but the fact that two-thirds of CFC profits are realized in tax havens indicates that tax planning is present. It is hard to say what fraction of tax haven profits are more properly viewed as having a U.S. source and therefore belonging in the state corporate income tax base. The average gross margin of the U.S. corporations and CFCs together was 7.9 percent. If the Form 1120 filers earned that gross margin instead of 5.2 percent, federal taxable income would have been almost $500 billion greater in 2010, of which approximately 60 percent would be attributable to outbound investors and 40 percent to inbound investors.[4] Not

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[1] *See* IRS, "2010 Statistics of Income: Corporation Income Tax Returns," tables 16 and 24.

[2] IRS, "SOI Tax Stats — Foreign Controlled Corporations."

[3] *Id.* Countries treated as tax havens for this calculation are the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, the Netherlands Antilles, Cyprus, Ireland, Luxembourg, the Netherlands, Switzerland, Singapore, and Hong Kong.

[4] The calculation is: The gross margin for the Form 1120 filers and CFCs combined is 7.9 percent ($1,764.5 trillion of combined profit for the Form 1120 filers and CFCs combined divided by $22.370 trillion of gross receipts after the intercompany receipts of the CFCs are netted). If that gross margin is applied to the sales of the U.S.-owned Form 1120 filers, the tax base increases from $815.3 billion to $1,091.7 billion, or $276.4 billion. Note that this represents approximately half the CFC profits realized in tax havens. If the gross margin

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all that additional federal taxable income would flow through to state tax bases because some states choose not to tax corporate net income, many exempt specific industries from net income taxation, and some federal taxable income is not U.S. source. Nonetheless, if those numbers are of the correct order of magnitude, it appears that BEPS is causing a significant revenue loss to the states and that both inbound and outbound investors contribute to the loss.

A 2007 Treasury study of earnings stripping suggested that when proper adjustments are made for industry mix and nonoperating income, foreign-owned U.S. corporations are no less profitable than U.S.-owned ones.[5] However, that does not necessarily mean that states should ignore inbound investors' BEPS, but rather that BEPS appears to be roughly similar for inbound investors as for U.S. entities generally.

Several features of the federal tax landscape appear to contribute to those disparities in apparent profitability. Because the federal tax system limits consolidation to U.S. affiliates, the transfer pricing of intercompany transactions between the U.S. and foreign affiliates of outbound investors can be an important determinant of the U.S. tax base, and the system appears to allow MNCs much flexibility in setting transfer prices to shift profits away from the United States, a jurisdiction with a relatively high tax rate by international standards. Taxpayers get to decide which affiliates hold which assets, take which risks, and perform which functions, and they take the first shot at identifying intercompany transactions and setting their prices. Because U.S. affiliates typically deduct expenses associated with the corporate headquarters, properly determining their income under existing law would require the IRS to proactively identify or develop specific intercompany transactions to reflect all the services and intangible assets that the headquarters provides to the foreign affiliates, a task that has proven challenging. Inbound investors are also not consolidated with their foreign parents and appear to have similar flexibility in transfer pricing, which their relatively low apparent profitability suggests is being used to strip significant income out of the U.S. tax base through deductible interest, royalty, and other payments to foreign affiliates.

II. The States' Policy Problem

While state treasuries could gain significant revenue by addressing BEPS, the problem is not a simple one for state policymakers. Conformity to the federal tax base, which means accepting whatever BEPS is inherent in that base, greatly simplifies compliance with and the administration of state taxes. Further, when states deviate from federal conformity in ways that increase the tax base, policymakers risk criticism that their state's tax climate is unfriendly to business, which can have political as well as economic repercussions. Foreign governments will likely object to state policies they perceive as burdensome to their businesses, adding a foreign policy dimension to the problem and potentially causing the federal government to pressure the states to accommodate foreign concerns. Lastly, some of the federal tax policy considerations that motivate the existing federal rules that facilitate BEPS may prove equally persuasive to state policymakers.

Despite the benefits of federal conformity, the state tax policy problem is different than the federal problem in some key respects, including:

- Federal policymakers continue to debate the relative roles of residence- and source-based taxation. The states operate a largely source-based system. Thus, states generally make no attempt to directly tax corporate income that is properly sourced to foreign jurisdictions, and in many cases they would be precluded from doing so because the U.S. Constitution, as interpreted by the U.S. Supreme Court, mandates that state taxes be fairly apportioned and related to services provided by the state.[6] MNC tax planning techniques that are designed to avoid U.S. or foreign tax on genuine foreign-source income under state sourcing rules should be of little direct concern to state policymakers.
- Federal tax law determines the source of net income using a two-step process. First, taxpayers determine the source of gross income. Second, they attribute expenses to that income. States use formulary apportionment of taxable income, which is a one-step approach. Further, federal sourcing rules mix origin- and destination-based principles, while states are increasingly adopting pure destination-based sourcing rules. Because federal and state sourcing rules are inconsistent, some income that is treated as foreign source under federal tax law and regulations is U.S. source under state tax laws. When states conform their base to the federal tax base, that inconsistency can aggravate BEPS at the state level, as discussed below.
- The extent of consolidation of commonly owned corporations determines which expenses are matched with what income and which intercompany transactions are respected. The federal system generally limits consolidation to U.S. corporations with a U.S. parent. States use various approaches to consolidation ranging

is applied to the sales of the foreign-owned U.S. corporations, the tax base increases from $127.2 billion to $324.2 billion, or by $197 billion.

[5]Treasury Department, "Report to the Congress on Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties" (2007). An exception is formerly U.S.-owned corporations that engaged in inversion transactions, which Treasury has acknowledged generate significant earnings stripping.

[6]*Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

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from no consolidation to elective worldwide consolidation of all commonly owned corporations conducting a unitary business.[7] A common approach is "water's-edge" consolidation, which consolidates U.S. corporations and unitary non-U.S. corporations with income effectively connected with a U.S. trade or business, sometimes with an option of worldwide unitary consolidation. Thus, federal and state tax systems will not generally match the same expenses with any given item of U.S.-source income.

- Federal tax law includes some policy instruments that states appear to be precluded from using because, if made a mandatory part of the tax calculation, they would be viewed as discriminating against foreign commerce. Those include withholding taxes on royalties, interest, dividends, and some other payments to foreign persons; the tax on transfers of intangible assets to non-U.S. affiliates under IRC section 367; and the inclusion of subpart F income in the tax base. In each case, states probably could not mandate the federal rule without applying a similar rule to domestic taxpayers, which is likely to prove infeasible or unattractive. The U.S. Supreme Court has ruled that conformity with federal law does not justify what would otherwise be impermissible discrimination against foreign commerce.[8]
- The U.S. Constitution, as interpreted by the courts and federal law, imposes restrictions on state taxation in addition to the nondiscrimination requirement. State taxes must be fairly apportioned so that the tax base properly reflects the income earned from the trade or business conducted in the state. States are precluded from taxing specific categories of taxpayers and types of income. For example, P.L. 86-272 precludes states from imposing net income tax on corporations whose only contact with the state is the solicitation of sales of tangible personal property plus ancillary or de minimis activities. States also cannot impose corporate income tax on corporations unless they have more than minimal contacts with the state.[9]
- The U.S. Treasury Department negotiates bilateral tax treaties with foreign governments, one goal of which is to address double taxation of the same income by both countries. Those treaties typically include a provision for bilateral reconciliation of inconsistent treatment of taxpayers through a competent authority process. As part of treaty negotiations, the United States agrees to tax reductions on foreign persons doing business in the United States in exchange for corresponding reductions by the foreign signatory for U.S. persons. Those reductions generally include waiving the right to impose income tax on inbound investors that do not maintain a permanent establishment. Except for the nondiscrimination article (which in any case would appear to overlap with U.S. constitutional restrictions on discrimination), those treaties generally do not apply to state taxation, although states that conform to the federal tax base will implicitly grant the treaty concessions to inbound investors that claim protection under the treaty. States, of course, cannot negotiate treaties with foreign governments and thus have no method to resolve double taxation issues except for unilaterally conceding the right to tax the income in question.
- Some federal tax policies that facilitate BEPS appear to be motivated at least in part by economic considerations. For example, attribution of a portion of U.S. headquarters or research and development expenses to CFCs, which some argue might better match expenses to U.S.-source income, has been resisted because of the concern that it would encourage U.S. MNCs to move those high value-added activities to foreign countries where the expenses would be fully deductible. Similarly, significant earnings stripping by inbound investors through royalty, interest, and other payments to overseas affiliates is defended as attracting inbound investment to the United States. While there is no clear reason why state policymakers should analyze the trade-off between the revenue and economic impacts of those policies any differently than their federal counterparts, some states may put more emphasis on revenue because they receive a disproportionately small share of the overall economic benefit or believe they are too small to affect MNCs' investment decisions.

Thus, despite the potential benefits to states of conforming to federal tax treatment of MNCs, there are several reasons why states must or are motivated to decouple their rules from the federal rules.

III. Possible State Policy Responses to BEPS

States have adopted various policies to address BEPS, including economic nexus rules, the denial of tax treaty benefits, addback rules, broader approaches to combined reporting, transfer pricing, and the taxation of a portion of CFC dividends. Those approaches are discussed below, along with the alternative of waiting for federal tax reform.

A. Economic Nexus

One advantage of an origin-based sourcing rule is that the state likely has taxing jurisdiction over all the corporations whose income originates in the state. That is not

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[7] Alaska mandates worldwide combined reporting for oil and gas companies.

[8] *Kraft General Foods Inc. v. Iowa Dep't. of Revenue and Finance,* 112 S. Ct. 2365 (1992). Iowa conformed its definition to the definition of federal taxable income by providing a dividend received deduction for dividends from U.S. corporations but not for those from foreign corporations. The Court held that to be discriminatory.

[9] *Complete Auto, supra* note 6.

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necessarily the case with destination-based sourcing. Therefore, as states move to destination sourcing, they are increasingly motivated to stretch their taxing jurisdiction to the maximum extent permissible. Economic nexus rules assert a state's taxing jurisdiction over out-of-state corporations that make sales to customers in the state (generally with a de minimis exception) regardless of whether the corporations have physical presence.[10] If an inbound investor's U.S. affiliate is stripping the U.S. tax base by deducting payments to a foreign affiliate for services or the licensing of intangible assets, a combination of economic nexus and destination sourcing can potentially counteract BEPS by partly or wholly offsetting the tax benefit of the U.S. affiliate's deduction with a tax on the net income of the foreign affiliate, whose "customer" is in the taxing state.

For economic nexus to counteract BEPS, states must decouple their rules from various aspects of the federal tax system. In a well-planned inbound investor structure, the foreign affiliate receiving the payment deducted by the U.S. affiliate will not maintain a PE in the United States and, if located in a treaty country, will not have any U.S. taxable income. Depending on the facts, the income may or may not be effectively connected with a U.S. trade or business. States could address the PE problem by disallowing treaty benefits in computing their tax bases, as is the case in New York and California, both of which use effectively connected income, not federal taxable income, as the starting point in the tax calculation by foreign corporations.

However, when the payments deducted by the U.S. affiliate do not produce ECI for the foreign affiliate, states must expand the tax base even further to include non-ECI for an economic nexus law to be effective. That is an example of a situation in which the inconsistency between state destination-based sourcing and federal origin-based sourcing can lead to BEPS unless states depart from federal conformity. For example, a royalty received by a foreign licensor for the use of intangible property within the United States would be U.S.-source income under a state destination sourcing rule but generally not ECI under the federal origin-based sourcing rule.

In addition to the need to decouple the state rules from the federal definition of taxable income, several issues arise in applying an economic nexus rule to foreign affiliates of MNCs:

- The constitutionality of economic nexus remains an issue. States' ability to extend their taxing authority to persons with limited presence in the state is restricted by both the due process and commerce clauses of the U.S. Constitution, but the contours of those limitations are unclear. The U.S. Supreme Court has refused to hear challenges to state economic nexus laws, and in most states, there has been no guidance from courts on the issue. When state courts have spoken, they have upheld economic nexus laws more often than not, including in cases involving the use of intangible assets to conduct business in a state and issuance of credit cards to customers in a state. However, most states cannot be sure that their economic nexus laws will be upheld by their state courts, nor can they be sure that the U.S. Supreme Court will continue its policy of nonintervention.
- Federal legislation could preempt state economic nexus laws.[11]
- There are likely to be enforcement challenges in asserting taxing jurisdiction over a foreign corporation with little or no physical presence in the United States, especially when there is no federal tax filing requirement. Without substantial outreach, many foreign corporations may be unaware of their state tax obligation.

New Jersey has been the most aggressive state in using economic nexus to collect tax from MNCs, but its experience is generally regarded as unsatisfactory. New Jersey has long had regulations providing that the starting point for the state tax calculation is a taxpayer's worldwide income, so federal conformity was not an obstacle to asserting economic nexus against foreign affiliates.[12] In 1996 the Division of Taxation issued new regulations taking the position that the use of intangible assets within New Jersey constituted doing business in New Jersey for purposes of the state's corporation business tax, a policy that was ultimately sustained by the New Jersey Supreme Court.[13]

In 2002 the State Legislature enacted an economic nexus law along with a throwout rule, which provided that sales to customers in states where the taxpayer did not pay corporate tax were thrown out of the numerator and denominator of the apportionment formula's sales factor. Following division policy, auditors began asserting economic nexus regarding recipients of royalty payments from affiliates using intangible property in New Jersey, including foreign licensors. Those assessments included application of the throwout rule, which in these circumstances could produce tax assessments on the licensors that were many times larger than the tax benefit the U.S. licensee derived from deducting the royalty payment. The resulting controversy eventually persuaded the division to cease applying economic nexus to foreign corporations that lacked ECI within the United States. It is an open question whether New Jersey would

[10]Those economic nexus rules generally do not apply to corporations whose business is limited to selling tangible personal property because state income taxes would be preempted by P.L. 86-272.

[11]H.R. 2992, the Business Activity Tax Simplification Act, would preempt state economic nexus laws and extend P.L. 86-272 protection beyond sellers of tangible personal property.

[12]However, the validity of those regulations has been thrown into question by the courts. *See IBM Corp. v. New Jersey Division of Taxation*, 26 N.J. Tax Ct. 102 (2011).

[13]*Lanco Inc. v. Director, New Jersey Division of Taxation*, 908 A.2d 176 (N.J. 2006).

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have been more successful had it applied economic nexus in a manner that merely counteracted the benefits of the royalty deduction by the U.S. licensee without adding the burdens imposed by the throwout rule (which has since been repealed).

Thus, while an economic nexus rule has specific advantages over other approaches discussed below because it taxes apportioned net income, its use to counter BEPS is not free from problems.

B. Denial of Treaty Benefits

For states whose courts have not upheld economic nexus laws or that would prefer a less controversial approach, one possibility is to decouple their rules from federal tax treaty provisions that waive net income tax on foreign corporations that lack a U.S. PE. It appears possible for a taxpayer to have significant physical presence in a state without developing a PE, so states do not need economic nexus to bring many of those foreign corporations into their tax base. To the extent that BEPS involves shifting ECI from a U.S. to a foreign affiliate with physical presence but no PE, that tax planning will not work in a state that has decoupled from the treaty benefit. As indicated earlier, California and New York have adopted that approach. While the benefits of the approach are limited, it also appears to have few downsides for states.

C. Addback Rules

One form of BEPS by inbound investors arises from deductible payments to foreign affiliates for intangibles or intercompany services. According to IRS data, in 2008 foreign-owned U.S. corporations with receipts of $500 million or more reported $112.2 billion of income subject to tax. Payments to related persons included interest ($68.1 billion); insurance or reinsurance premiums ($29.6 billion); royalties and other payments for intangibles ($16.6 billion); commissions ($7.8 billion); and payments for technical, managerial, and similar services ($29.5 billion).[14] Thus, those expenses stripped more than half of taxable income from the tax base. Of course, some level of expense for those items would be normal, so it cannot be assumed that this earnings stripping represents anything undesirable or inappropriate.

Federal tax law limits earnings stripping through IRC section 163(j), which defers deductions for excess amounts of disqualified interest. Disqualified interest is interest on money borrowed from or debt guaranteed by a related party, when the interest income is not subject to U.S. tax — that is, the lender is foreign or a tax-exempt organization — and the taxpayer's debt-equity ratio exceeds 1.5. Excess disqualified interest is interest that exceeds 50 percent of taxable income, determined without regard to the interest deduction. States generally conform to that federal rule.[15]

Many states have enacted their own earnings stripping rules, called addback laws. Those typically apply to royalty payments to related parties; however, some apply to interest and other payments as well. Effectively, the taxpayer is denied a deduction for payments subject to addback, but the laws typically contain several exemptions to address situations in which the deductions are deemed not to provide unwarranted tax benefits. One common exemption is for situations when the payment subject to addback is offset by related income — for example, when the taxpayer is both receiving royalty income and making royalty payments for the same intangible asset (conduit exemption). A second common exemption is for situations when the licensors pay state tax on the income from the intangible at more than a specific tax rate (subject-to-tax exemption).

As drafted, the addback laws do little to address BEPS by MNCs because a third common exemption is for payments to affiliates in countries with which the United States has a comprehensive tax treaty (tax treaty exemption). Following a recommendation of his Tax Reform and Fairness Commission, New York Gov. Andrew Cuomo (D) recently proposed to repeal that exemption but withdrew the proposal after inbound investors expressed concern that doing so would discourage investment and subject royalty payments to double taxation (once by New York on the licensee and a second time by whatever foreign country imposes tax on the licensor).

Neither of those objections to Cuomo's proposal appears warranted. If a state has adopted destination sourcing and economic nexus, it is unclear why broadening an inbound investor's tax base by adding back royalty payments would affect its incentive to use property or payroll in the state. Assuming the state tax is not so burdensome as to affect the taxpayer's decision whether to invest in the United States and that economic nexus would operate to subject the taxpayer to tax even if it moved all property and payroll out of state, the inbound investor might not like the additional state tax arising from the addback but would be unable to reduce it by unilateral action other than changing the location of its customer base. It is also unclear why states should be concerned about double taxation of the royalty payment by a foreign country, as all subnational taxes impose burdens over and above those of national taxes.

Addback laws do run the risk of being unfair to taxpayers in a different, and perhaps more problematic, respect. When a payment is added back to the payer's taxable income, there is no allowance for any costs incurred by the related-party recipient, such as expenses incurred in providing a service or

[14]IRS, "SOI Tax Stats — Transactions of Foreign-Owned Domestic Corporations."

[15]It would appear that conformity to the federal earnings stripping rule does not discriminate against foreign commerce because it applies to payments to all federally tax-exempt payees, whether foreign or domestic.

developing an intangible. When those costs are low (as might be the case if transfer pricing is extremely aggressive), that may not be a significant issue, but there will be cases in which adding back produces distortions because significant costs are involved. In contrast, applying economic nexus and taxing the recipient of the intercompany payment would avoid the distortion because expenses would be deductible in computing the recipient's taxable income.

A second issue with addback laws in general is that they may not do a good job of distinguishing between abusive and non-abusive situations. Not all intercompany payments are alike. Because foreign parent companies get to choose the extent to which they fund their U.S. subsidiaries with debt or equity, excessive debt-equity ratios, the target of section 163(j), may be viewed as inappropriate tax planning. However, when foreign parents provide services or intangible assets to their subsidiaries, international transfer pricing norms mandate that an arm's-length payment be made by the U.S. subsidiary, so the existence of those deductions is not necessarily an indication of inappropriate tax planning, assuming the transfer pricing is reasonable. Thus, it may be desirable to limit the application of addback laws to situations in which planning appears aggressive.

One approach might be to repeal the tax treaty exemption but limit the application of the addback laws in those cases to payments in excess of a percentage of taxable income, similar to section 163(j). To avoid a challenge on grounds of discrimination, a state limiting its tax treaty exemption would presumably have to extend its other exemptions to ensure parity between U.S. and foreign persons.

Thus, addback laws may be a weapon for states to combat BEPS, especially by inbound investors, but they have important limitations.

D. Broader Approaches to Combined Reporting

Another approach to combating BEPS is to broaden combined reporting.[16] If the affiliate to which profits are shifted is added to a U.S. combined group, its income is brought back into the tax base. In contrast to addback rules, the problem of mismatch between income and expenses is addressed because the affiliate's expenses are deducted, and the affiliate's apportionment factors are accounted for, in the apportionment formula. If the apportionment formula is reasonable, the proper tax is collected.

The broadest approach to combined reporting is mandatory worldwide combined reporting. The tax base would be determined using the income, expense, and apportionment factors of all affiliates conducting the unitary business. In theory, that approach would produce the most accurate measure of the MNC's state corporate tax base. However, mandatory worldwide combined reporting presents several important problems. It can involve significant complexity for taxpayers, who would be expected to compute U.S. state taxable income for every state in which they do business for each one of their unitary worldwide affiliates, many of which have no reason to compute even U.S. federal taxable income. The U.S. affiliates, which are the legal entities over which states have taxing jurisdiction, may not have the legal right to get the information they need to file the worldwide combined return from their foreign affiliates. States' ability to audit the worldwide combined return in those cases might be limited. Finally, in the past, foreign governments have expressed concern to the federal government over that issue, leading to federal pressure on states not to use that method.[17] Mandatory worldwide combined reporting appears to be outside the acceptable policy debate.

A more limited approach, used by several states, would be to extend combined reporting to unitary corporations incorporated in tax havens. The tax returns of corporations in tax havens are likely to be much simpler than those of corporations located in countries where real business activities are conducted, so that compliance costs would be reasonable, and the tax haven governments are not well positioned to generate sympathy in Congress. Montana and Oregon use that approach and include a list of tax havens in their statutes; West Virginia and the District of Columbia use a similar approach and delegate the designation of tax havens to the state revenue department. Unsurprisingly, foreign countries have objected to their designation as tax havens, so far without apparent influence on the outcome.

The income that CFCs accumulate in tax havens includes a mix of income that might properly be viewed as U.S. source and income that is properly viewed as foreign source. Merely adding the tax haven subsidiary's apportionment factors to the U.S. combined return does not necessarily provide adequate factor representation for the foreign-source portion of the tax haven income. For example, an MNC planning structure may involve affiliates that make sales and use property and payroll in high-tax foreign countries, and that pay interest and royalties to an affiliate in a tax haven to strip the net income out of the high-tax foreign countries' tax bases. The tax haven affiliate's apportionment factors would include the interest and royalty receipts and whatever limited property and payroll it has, not the much larger amounts of sales, property, and payroll used to generate the group's genuine foreign-source income. The apportionment formula denominator in the combined return would therefore mix what is in effect net income from the foreign activities with gross income from U.S. activities, creating a distortion that sources too much income to the United States. One approach might be to exclude a portion

[16]The terms "combined" and "consolidated" reporting are used interchangeably.

[17]In the 1980s, the federal government successfully pressured states to drop mandatory worldwide combination.

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of the income received by combined tax haven affiliates as a "rough justice" approach to compensate for inadequate factor representation.

A second way to address that distortion would be to permit taxpayers to choose between the state's basic system, which would include combination of unitary tax haven CFCs, and worldwide combination. Presumably, any taxpayer who considers the distortion too severe could make the worldwide election. Several states allow such an election, including Montana. However, as is the case with any election, taxpayers will make use of it when it reduces their tax liability, which will produce state revenue loss that must be offset against the revenue gain from expanding combined reporting to tax havens.

An important attraction of a worldwide combined reporting election is that the U.S. Supreme Court has sustained the constitutionality of mandatory worldwide combined reporting, contingent on states making reasonable efforts to ease the compliance burdens.[18] When a state makes that choice available, it can add features to its base tax calculation that, if mandatory, would not withstand constitutional scrutiny. In effect, the taxpayer must accept those features as a condition of electing out of worldwide combined reporting. In that structure, for example, states can provide for the inclusion of a portion of dividends or subpart F income earned by unitary CFCs (discussed below) in the base tax calculation even though, absent the worldwide election, that approach would not be sustainable under *Kraft*. Similarly, states may require that as a condition of electing out of worldwide combined reporting, unitary affiliates with sales to customers in the state file returns and pay tax on their net income in compliance with economic nexus laws.

Whether those approaches are attractive for states may depend on how the revenue loss from a worldwide election stacks up against the revenue gain from the anti-BEPS provisions added to the basic tax calculation.

E. Transfer Pricing

One response to state frustration with federal transfer pricing rules and their administration would be for states to do the transfer pricing themselves. States could conduct their own transfer pricing analysis under the federal standards or adopt their own rules.

Individual states have generally been reluctant to make the investment needed to perform sophisticated transfer pricing analysis. Several states have relied on outside contractors to do the analysis, which has raised questions about the impact of the contractors' fee arrangements on the impartiality of the studies. The Multistate Tax Commission recently started a project involving nine states to do transfer pricing analysis. It would permit states to share the cost and presumably would result in higher-quality analysis and less controversial fee arrangements with outside contractors. The director of the project design team has indicated that the project will consider deviating from federal transfer pricing rules and may address transactions between MNCs' U.S. and foreign affiliates.[19]

State attempts to challenge MNCs' transfer pricing between U.S. and foreign affiliates are likely to prove challenging. If states deviate from the federal transfer pricing rules (the regulations under IRC section 482), they risk losing the revenue from the flow-through of federal audit adjustments to the state tax base. Taxpayers are likely to take the position that the federal adjustments do not apply at the state level because the rules are different, a loss that could easily dwarf whatever revenue states expect to derive from their own transfer pricing audits. If states attempt to apply the section 482 regulations to transactions between U.S. and foreign affiliates, they are likely to be facing off against taxpayers who have developed substantial transfer pricing documentation for federal and international tax purposes, have undergone federal audits of their transfer pricing, or have negotiated advance pricing agreements with the IRS. In those cases, a large investment by the states would be necessary to mount successful challenges. Legal challenges to state transfer pricing assessments will be heard by state courts, which are likely to have limited interest in grappling with the intricacies of transfer pricing and a limited ability to understand it.

Thus, state transfer pricing analysis is likely to have limited value in combating BEPS by MNCs.

F. Taxation of CFC Dividends and Subpart F Income

Most states provide a 100 percent dividend received deduction (DRD) for dividends from foreign subsidiaries. However, dividends paid by CFCs and income that is treated as a dividend under IRC subpart F can be distributed from income that is more properly sourced to the United States under state sourcing rules. States could try to bring that income into their tax base by reducing the DRD on CFC dividends and subpart F income.

There appears to be no constitutional prohibition on state taxation of dividends from subsidiaries that are unitary, with an affiliate that does business in the state.[20] However, under *Kraft*, states cannot treat CFC dividends less favorably than dividends from U.S. subsidiaries in connection with a mandatory tax calculation.

That nondiscrimination requirement poses a problem because, from the standpoint of tax policy, the DRD plays very different roles for domestic and foreign dividends. For dividends from domestic subsidiaries, the DRD operates to address double taxation because it can be presumed that the

[18]*Barclays Bank PLC v. FTB*, 512 U.S. 298 (1994).

[19]Amy Hamilton, "States Designing a Multistate Transfer Pricing Audit Program," *State Tax Notes,* Mar. 17, 2014, p. 621.

[20]*Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425 (1980).

dividend payer, in addition to paying federal income tax, was taxed on its income in the various states in which it did business. However, for CFC dividends, especially those distributed from subsidiaries located in a tax haven, double taxation would not appear to be an issue because there is no reason to believe that the payer's income would have been subject to meaningful national or subnational taxation. Rather, for CFC dividends, the DRD compensates for the fact that part of the dividend likely represents the distribution of income properly treated as foreign source. A 100 percent DRD effectively assumes that the dividend is paid entirely from income properly treated as foreign source under state sourcing rules. In effect, a partial DRD for CFC dividends would represent a rough estimate of the amount of the dividend properly viewed as U.S. source. Because the rationales for a DRD are so different for domestic and CFC dividends, the nondiscrimination requirement imposed in *Kraft* makes it difficult to determine the appropriate level for the DRD in a state that wishes to reduce the DRD to below 100 percent to offset some of the impact of BEPS. As with rough estimates, the rule will be too harsh on some taxpayers and too lenient on others.

As discussed above, one way around the nondiscrimination requirement would be for states to provide a worldwide combined reporting election.

G. Federal Tax Reform

Perhaps the best outcome for states would be federal tax reform that created a U.S. tax base that satisfied states and that they could apportion without any state-only approaches to addressing BEPS. Unfortunately, the federal tax reforms under consideration would only go partway in that direction.

Some proposals to broaden the federal corporate tax base would generally flow through to state tax bases under existing law. Those include tighter earnings stripping rules on inbound investors, the deferral of deductions by U.S. taxpayers attributable to deferred CFC income, and the denial of interest and other deductions deemed attributable to foreign-source income. A reduction in the federal corporate tax rate should reduce the incentive to shift income outside the United States, as should action by high-tax foreign jurisdictions to limit BEPS for their own countries. Similarly, a reduced tax rate on royalty income of U.S. taxpayers derived from foreign licensees, known as a patent box, could encourage taxpayers not to transfer their intangibles to overseas affiliates and thus outside the existing state corporate tax base.

However, other anti-BEPS proposals would not necessarily flow through to the state tax base under existing law. For example, proposals to expand anti-deferral provisions like subpart F would not flow through because states typically do not tax subpart F income. Neither would proposals that would encourage or force repatriation of the retained earnings of CFCs because states typically exempt all or most CFC dividends. States would need to change their laws for those proposals to expand the state tax base.

In some cases, Congress may view those proposals as alternatives. For example, the proposed territorial tax system of House Ways and Means Committee Chair Dave Camp, R-Mich., would permit a 95 percent DRD for CFC dividends. The Joint Committee on Taxation's explanation of the proposal says the 5 percent inclusion of those dividends in the tax base is intended to compensate for the failure to attribute any expenses to the exempt income, which if done directly would flow through to the state tax base.

Thus, states cannot be assured that federal tax reform to limit BEPS would solve their problem unless they are prepared to change their laws.

IV. Conclusion

Except perhaps for denying treaty benefits, none of the proposals discussed above is free from problems. Discriminating between domestic and foreign dividend income and economic nexus raises constitutional issues unless made elective, and revenue gain from enacting any change must be weighed against any revenue loss from the election. Add-back laws and extending combined reporting to tax havens introduce new distortions to the tax calculation. Mandatory worldwide combination and economic nexus are subject to a risk of federal preemption. A partial DRD for CFC dividends and partial inclusion of tax haven income produce only a rough approximation of the proper tax base, which is generally problematic in tax legislation. State transfer pricing of MNC intercompany transactions will not be successful without an investment that states are unlikely to make. Patiently awaiting federal tax reform promises only a partial solution. It is easy to understand why state policymakers want to capture some of the revenue loss from BEPS; it is harder to determine the best way to do it. ✰

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