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State Taxation of MNEs Under the TCJA: It's Time for a Policy Reassessment

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In this article, Fort comments on how states have responded to the Tax Cuts and Jobs Act of 2017 and how they are likely taxing multinational enterprises at a far lower effective tax rate than their domestic counterparts.

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The passage of the Tax Cuts and Jobs Act in the final days of 2017 ushered in unprecedented changes to the federal corporate income tax code, prompting some but not all state legislatures to address how their states should conform to the new federal provisions.

It's fair to say that policymakers were slow to appreciate the enormity of the changes wrought by the 114th Congress and the impact those changes might have on state corporate tax revenue. Many legislatures were quick to decouple from the TCJA's new limitations on interest expense and net operating loss deductions, presumably motivated by a desire to increase their states' economic competitiveness. Those new provisions applied equally to all taxpayers, were easy to understand, and the fiscal implications of decoupling were relatively easy to predict.

The core of the TCJA, however, addressed the application of the federal tax code in the realm of international commerce. Most significantly, the TCJA eliminated federal taxation of foreign dividends, moving the federal tax code closer to a pure territorial system of taxation. A slew of confusing new provisions with clever acronyms went into effect almost overnight, intended to encourage domestic activity while discouraging profit shifting to foreign subsidiaries. Congress deemed it necessary to graft these new provisions onto the federal code because, with the elimination of tax on foreign dividends, multinational taxpayers would otherwise have had an even stronger incentive to shift profits to their overseas subsidiaries.

Six years after the passage of the TCJA, state tax policies relating to the new quasi-territorial system of taxation can only be described as a patchwork affair, often lacking theoretical consistency and economic justification. In conforming to only parts of the TCJA, and as a consequence of previous nonconformity choices, most states are likely imposing income taxes on multinational business enterprises at a far lower effective rate (measured in relation to federal taxable income or book income) than they impose on their purely domestic counterparts. It is time for the states to reassess whether their tax structures should be modernized to ensure parity in tax burdens among those engaged in domestic and foreign commerce.

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I. The TCJA in a Nutshell

Most state policymakers probably understand that the TCJA, as its name implies, was intended to increase economic activity in the United States. It does so by:

- dramatically lowering the federal corporate income tax rate from 35 percent to 21 percent;
- moving the country further toward a territorial taxing system by eliminating taxation of dividends derived from the activities of foreign subsidiaries; and
- by adopting other provisions to encourage U.S. corporations to bring back profits derived from international transactions.

A. The Transition Tax on Deferred Profits

By far the most significant aspect of the TCJA was the elimination of tax on foreign dividends.[1] To prevent a windfall to U.S. corporations that had deferred recognition of their earnings from investments in foreign subsidiaries (controlled foreign corporations), the repatriation transition tax (RTT), codified as IRC section 965, imposed a one-time tax on the deemed repatriation of CFC profits accumulated since 1986 but at a significantly reduced effective tax rate.[2]

The astonishing aspect of the RTT was its timing. The TCJA was passed by Congress on December 20, 2017, and signed into law by then-President Trump on December 22, 2017. The outlines of the proposed tax had been revealed by the congressional taxwriters only a few weeks before that. Yet, the new tax was effective for the 2017 tax year, a period that ended for most taxpayers just days after its enactment. The effective date of the RTT's imposition provided little opportunity for state tax policymakers to decide what to do regarding hundreds of billions of dollars suddenly brought into the federal tax base. Getting ahead in the story somewhat, because the RTT income inclusion was defined as an increase in subpart F liability and because subpart F income was not part of the tax base in most states, as explained later, little of the repatriated income was subject to tax by the states. For most states (and most taxpayers), it is now water under the bridge.[3]

B. FDII and GILTI

The TCJA introduced two new major conceptual frameworks that affected the taxation of multinational corporations, designed to work in tandem as a carrot-and-stick approach to address profit shifting outside the U.S. tax base.

The "carrot," meant to encourage multinational corporations to on-shore profits, is called the foreign-derived intangible income deduction, codified as IRC section 250, which provides a reduction of 37.5 percent of income derived from the "intangible values" associated with goods and services sold overseas. It is a substantial deduction, amounting to $71 billion in 2020, the most recent year for which data is available.[4]

Global intangible low-taxed income, codified as IRC section 951A, is the primary "stick" intended to discourage domestic profit shifting to related overseas entities. GILTI subjects domestic owners of foreign subsidiaries to tax on their CFCs' "extraordinary" overseas profits. Extraordinary profits are measured by the excess over a presumed ordinary rate of return of 10 percent on the value of depreciable assets held overseas. The theory behind GILTI is that profits above that benchmark should be attributable to intangible property values that, in the international system, often go untaxed.

GILTI provides for an 80 percent credit on foreign taxes paid, thus acting as a top-off tax on

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[1] Ordinary foreign earnings have been subject to deferral since the beginnings of the federal tax system in 1913. "Income deferral" also applies to the owners of domestic corporations, of course — the owners are only subject to tax on those earnings when dividends are paid — but those corporate earnings have already been taxed at the entity level. By that measure, one could argue that the long-standing deferral of tax on foreign corporate earnings constituted a kind of favoritism toward those investing in overseas activities.

[2] The transition tax is being challenged as an impermissible federal tax on "property" in the case of *Moore v. United States*, 36 F.4th 930 (9th Cir. 2022), *cert. granted*, No. 22-800 (U.S. 2023)). The case will likely not have any effect on state income taxation.

[3] Nebraska is in litigation over whether the transition tax is an excludable "deemed dividend" under that state's statutes or something else entirely. *Precision Castparts Corp. v. Nebraska Department of Revenue*, Dkt. No. A-23-0564 (Neb. Dist. Ct. June 30, 2023).

[4] Wharton School, University of Pennsylvania, Budget Model, "Did Tax Cuts and Jobs Act of 2017 Increase Revenue on US Corporations' Foreign Income?" at 7 (Oct. 12, 2023) (hereafter, Wharton Report).

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that revenue. The overall effective federal tax rate on GILTI is intended to be 13.3 percent, still substantially under the federal tax rate for domestic entities. GILTI is calculated on a worldwide basis, not country-by-country, so its utility as an antiabuse provision is limited, as it does not directly affect income shifting to tax haven countries. Federal taxpayers reported $440 billion of GILTI income in 2020, although with the deduction provided for in IRC section 250, the amount included in the federal tax base was reduced to $225 billion.[5] Calculation of GILTI and the associated foreign tax credit is complex, likely contributing to the paucity of state-level policy discussions as to how to address it.[6]

C. Subpart F Income

One of the most important aspects of the TCJA is what was not changed in the move to quasi-territorial taxation — the continued taxation of subpart F income. Congress enacted the subpart F rules (IRC sections 951-964) in 1962, to discourage profit shifting by U.S. corporations and individuals to countries with low or no tax rates. Broadly speaking, subpart F income encompasses the nonoperational or "passive" income of CFCs nominally earned in low-tax countries. Examples of qualifying passive income include royalties, gains from the sale of investment properties, premiums from insuring U.S. property, interest, rents, and — oddly — the amount of bribes paid to foreign officials.[7] The U.S. shareholders of a CFC are required to report those earnings immediately, with a previously allowed deduction for any amounts that are eventually repatriated as an ordinary foreign dividend, to avoid double taxation.

Although subpart F income certainly bears a relationship to true foreign dividends, it addresses different kinds of earnings based on starkly different policy considerations.[8] In contrast to ordinary foreign dividends, which can include operational income, subpart F income is limited to passive earnings and similar types of income that are not clearly related to commercial activity occurring overseas.

The scope and effectiveness of subpart F has been diminished over the decades, especially with the adoption of the "check the box" rules in 1997 that allowed certain transactions by covered CFCs to other CFCs to be disregarded.[9] Subpart F accounted for $43.6 billion in federally taxed income in 2020.[10]

Together, the FDII deduction, the GILTI inclusion amount, and subpart F income accounted for $339 billion out of a federal base of $2.67 trillion, or about 13 percent of the base. The impact on state revenue from conformity or nonconformity to FDII, GILTI, and subpart F income is bound to be substantial, by virtue of their magnitude alone. But perhaps more significantly, the tax consequences of conformity or nonconformity fall asymmetrically on the business tax-paying community because these provisions apply only to corporations engaged in international commerce.[11]

II. The State of State Conformity to the Federal Tax Base of Multinational Business Enterprises

A. State Treatment of GILTI

In the hectic days following the passage of the TCJA, the initial responses were driven by state statutes specifying how and when the states would conform to changes in the federal tax code. About half the states, so-called rolling conformity states, conform to federal changes automatically without further legislative action. A slightly

[5] *See* Tax Foundation TaxEDU, "Global Intangible Low-Taxed Income" definition.

[6] One other "stick" employed by the drafters of the TCJA was a new alternative minimum tax with yet another clever acronym, BEAT (for base erosion and antiabuse tax), now codified as IRC section 59A. The tax imposition is not part of the federal income calculation and thus states would have had to adopt it by separate legislation. None did. BEAT accounts for just $2 billion in revenue per year, as taxpayers have changed their accounting to respond to it.

[7] IRC section 952(a)(4).

[8] The passage of subpart F has been described as a compromise between two competing economic principles: capital import neutrality, which supported the policy of deferral of income tax on foreign earnings, and capital export neutrality, which suggested that such earnings were more appropriately taxed immediately, and at prevailing U.S. rates, to avoid favoring overseas investments. *See* National Foreign Trade Council, Archives, "The Deferral Principle."

[9] *See* J. Clifton Fleming, "Acknowledging (Celebrating? Regretting?) 60 Years of Subpart F," 51 *Intertax* 519, Issue 6 and 7 (2023).

[10] Wharton Report, at 6 (chart).

[11] The total federal corporate tax base in 2020 was $2.67 trillion. *See* IRS Pub. 16 (rev. Aug. 2023).

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smaller number, so-called static conformity states, conform to the federal code as of a certain year. The remainder of the states use a mix of static and rolling conformity, depending on the particular code sections identified in their statutes.[12]

Many state revenue agencies determined that GILTI was essentially a foreign dividend subject to a total or partial state dividends received deduction (DRD). Most states allow a 100 percent deduction of foreign dividends and most domestic dividends, while a smaller number of states allow deductions of 80 percent to 95 percent, with just a few states allowing for a 50 percent DRD. The exact nature of GILTI — as foreign income, domestic income, or a blend of both — is subject to debate, but there is no basis to treat it as a dividend. Nevertheless, no legislature has sought to reverse the initial state determinations that GILTI should be treated as a dividend subject to the state's DRD.

Apart from the question whether GILTI should be classified as a dividend subject to a state's DRD as a matter of statutory interpretation, a shroud of uncertainty hung over the states' ability to include GILTI in the tax base as a constitutional matter and, if so, on what terms. Those two considerations were presumably what motivated the majority of states to decouple from IRC section 951A almost immediately.

The states' early struggles with understanding how the TCJA related to their existing tax systems' conformity to the TCJA, as interesting and frustrating as that was, need not detain us further, as the states have now had six years to decide what they actually want to do about the TCJA independently of their prior statutory frameworks.

State treatment of GILTI has generally followed the states' treatment of subpart F income and foreign dividends, but there are exceptions. Half of GILTI income is deducted federally under IRC section 250, the same code section that provides a deduction for FDII. State survey responses have not always been clear as to whether states that do not tax GILTI allow the IRC section 250 GILTI deduction. While most states have treated GILTI as a foreign dividend subject to their DRD provisions, survey responses do not make it clear whether that DRD deduction applies to the amount computed after the IRC section 250 deduction is taken. It appears that all states that include GILTI in the tax base also allow the 50 percent deduction in IRC section 250.[13]

Several states that exclude GILTI from the state tax base have specific statutory or administrative provisions requiring taxpayers to add back expenses associated with exempted or deductible income amounts.[14] These provisions may be of limited utility, however, in balancing out the effects of GILTI exclusion since it represents extraordinary profit from intangible values. It would be difficult to isolate the expenses related to GILTI from the overall operational activities of the taxpayer. Still, the disallowance of related expenses is an appropriate and necessary adjustment for states choosing to decouple from IRC section 951A.

B. State Conformity to FDII

State conformity to FDII, as a special deduction reported on line 29 of the federal Form 1120, was initially driven in part by whether the states used line 28 or line 30 as the starting point for calculating state base income. State legislatures eventually addressed the issue of conformity, driven in part by whether the states taxed some or all of GILTI, but there is no consistent pattern among the states correlating the treatment of the two provisions.

Of the 13 states that don't allow the federal deduction for FDII, only Maine and Utah include a significant portion of GILTI (50 percent) in their tax bases. The other states that de-conform from the federal FDII deduction are California (static conformity to the federal 2015 tax year), Hawaii,

[12] Further complicating matters, some states conformed to the code as in existence at the beginning of the calendar year, but the RTT took effect immediately for the 2017 tax year although it was not part of the code in January of that year.

[13] The following jurisdictions include GILTI in their tax bases: Alaska, Colorado (partial), District of Columbia (no guidance issued), Idaho, Illinois, Indiana, Maine, Maryland, Massachusetts (5 percent), Minnesota, Montana (20 percent), New Hampshire, New Jersey (5 percent), New York (5 percent), North Dakota (50 percent), Oklahoma (allocated to commercial domicile), Oregon (20 percent), Tennessee (2.5 percent), Utah (50 percent), Vermont, and West Virginia. Information on state conformity to GILTI and FDII was drawn from Bloomberg Tax, "State Tax Chartbuilder." The information was not independently verified.

[14] *See, e.g.*, Kentucky Reg. 103 KAR 16:060.7.

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Illinois, Massachusetts, Minnesota, New Jersey, New York, Pennsylvania, South Carolina, and Wisconsin.

C. State Treatment of Subpart F Income

Alaska, New Hampshire, and Vermont appear to be the only states to include all of a taxpayer's subpart F income in the tax base. Another 14 combined filing states include between 5 and 50 percent of subpart F in the tax base, while the remaining states, including all separate-entity states, exclude it entirely.[15] The states that tax a portion of subpart F income generally afford identical treatment to actual foreign dividends. The states' partial inclusion percentages are usually justified as a kind of rough estimate of the expenses associated with the creation of that income. Stated differently, the reduced inclusion rates for dividends and subpart F income acts as an estimate of what the tax effects would be under a worldwide combined return, where all income and apportionment factors of the CFCs would be included, reducing the state's apportionment ratio while expanding the tax base.

Applying the same inclusion rate to true foreign dividends and subpart F income is questionable, however, because given the nature of subpart F income, it is highly unlikely that the CFC generating that income would have significant property, payroll, or sales located anywhere.

Overall, the states' treatment of subpart F income for water's-edge combined filers (either excluding the income entirely or including only a small percentage of it) likely constitutes a tax preference for multinational corporations when compared with their domestic counterparts, which lack the ability to isolate passive income in CFCs.

The same is true for the separate entity states as well; subpart F income will likely be reported by a holding company or other domestic subsidiary lacking nexus with the taxing state. The exclusion of subpart F income, either as a result of entity isolation strategies or as a DRD, skews the calculation of taxable income in a way that favors those engaged in multinational activity. The states cannot rely on IRS transfer pricing adjustments to recapture this income through audit enforcement since it is already in the federal tax base by virtue of the subpart F provisions.

III. The Price of Nonconformity

A. Water's-Edge Filing and Domestic 80/20 Companies

States tie their definitions of taxable income to federal standards based on the reasonable assumption that the code's writers have balanced the calculation of income and expenditures to fairly reflect taxpayers' net incomes from an economic and accounting perspective.[16] The TCJA should be seen in that light as well; the drafters presumably did not set out to reward or punish those engaged in international commerce compared with their wholly domestic counterparts.

Departures from the federal system carry with them the potential for anomalous tax results. Separate entity states, for instance, leave themselves open to innumerable income-shifting ploys because the code encourages transfers of property between domestic subsidiaries without income recognition. The nonrecognition treatment of such transfers under IRC section 351 is appropriate for federal tax purposes because, unlike state tax systems which have limited taxing jurisdiction, the code is designed to operate in a system in which all domestic companies are equally subject to tax, with commonly controlled companies almost always filing on a consolidated return basis.

Combined reporting is the antidote to such income shifting. The majority of states have now settled on a so-called water's-edge combined reporting system, as opposed to worldwide combined reporting or separate entity filing,

[15] States taxing all or a portion of subpart F income are Alaska, California (25 percent), Colorado (varies), Idaho (50 percent), Kansas (20 percent), Maine (50 percent), Massachusetts (5 percent), Minnesota (50 percent), Montana (20 percent), New Hampshire, New Jersey (5 percent), New York (5 percent), North Dakota (50 percent), Oklahoma (allocated to commercial domicile), Oregon (20 percent), Utah (50 percent), and Vermont, according to Bloomberg Tax.

[16] There are, of course, many policy choices embedded in the code as well, both obvious and subtle, such as accelerated depreciation or expensing for business property.

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precisely because the composition of the water's-edge combined group so closely parallels the federal consolidated group. This congruence allows the states to rely on federal tax determinations and federal consolidation rules to establish an appropriate baseline for state tax liabilities.

The states' water's-edge filing groups do not always conform to the federal consolidated group, however, and that lack of conformity allows many multinational corporations to significantly reduce their state tax liabilities in a manner that is simply not available to their wholly domestic counterparts.

So-called 80/20 companies are traditionally defined as U.S. or foreign corporations that have at least 80 percent of their property and payroll located overseas. Thirteen states exclude 80/20 companies from their water's-edge combined returns, even though these entities are subject to federal tax and included on the federal consolidated return.[17] Although the 80/20 exclusion traces its roots to the mid-1980s, a plausible policy rationale for this treatment has yet to be identified. Because traditional 80/20 companies are domestic entities for federal tax purposes, it is possible to transfer intangible property to them without income recognition.[18] As the ongoing *PepsiCo* litigation in Illinois demonstrates, an 80/20 company can be used to shelter income arising from entirely domestic activity.[19] Despite its long history as a feature of many states' combined filing regimes, there have been no comprehensive studies identifying the fiscal impact of the 80/20 exclusion.[20]

[17]The jurisdictions allowing the 80/20 exemption are: Alaska, Arizona, Colorado, Connecticut, District of Columbia, Illinois, Kentucky, Montana, New Hampshire, New Jersey, New Mexico, and North Carolina. The Multistate Tax Commission's own model combined filing statutes would exclude from the water's-edge combined filing group only foreign entities that have more than 80 percent of their property, payroll, and sales overseas.

[18]The definition of property excludes intangible property, paving the way for the creation of a company with limited overseas assets earning substantial amounts of income from the domestic exploitation of intangible property.

[19]*PepsiCo Inc. & Affiliates v. Illinois Department of Revenue*, Dkt. Nos. 16 TT 82 and 17 TT (2021).

[20]For an additional example of the potential scale of the problem, consider *Target Brands Inc. v. Department of Revenue*, No. 2015CV33831 (Colo. Dist. Ct. Jan. 27, 2017). The district court found that by transferring its domestic trademarks to a five-person 80/20 company, Target was able to deduct $17.9 billion in royalty payments over 10 years, virtually eliminating its corporate tax liability.

In addition, it is worth noting that 80/20 companies can be used as a conduit for reporting the federal consolidated group's GILTI liabilities and subpart F income, isolating that income from the water's-edge group. The amount of otherwise taxable GILTI income flowing into these 80/20 companies is simply unknown. Many combined filing states may accordingly be missing out on GILTI income even while allowing the corresponding deduction for FDII.

B. The Magnifying Effects of Net Income Calculations

Federal and state income taxes are imposed on a net basis, after deductions are allowed for expenses.[21] This means that relatively small reductions in federally taxed revenue, whether based on policy considerations or perceived constitutional limitations, can have an outsize effect.

Because the earnings of 80/20 companies and subpart F payers are often termed "foreign-source" income, it can be difficult to convince policymakers that such earnings should be in the states' tax base, especially when the amounts at stake appear to be relatively trivial. The tax effects from excluding this revenue can be significantly magnified, however, because it is almost impossible to identify discrete expenses associated with earnings from passive income and intangible property values.

Consider this example: ABC Corp. enjoys a 10 percent profit margin on its worldwide income; it has gross receipts of $10 million and expenses of $9 million for a net taxable income of $1 million. Assume that 5 percent of ABC Corp.'s gross receipts ($500,000) are subpart F income. The legislature is informed that subpart F income bears similarities to true foreign dividends, and the states' ability to tax such dividends has been challenged (see Section IV.D, below). It is suggested that perhaps the state shouldn't tax subpart F "to avoid the risks of litigation." The legislature responds by exempting what appears to be a small, disputed amount of federally taxed income from the state base. Yet by doing so, the

[21]The federal tax base in 2020 consisted of $33.4 trillion in income and $31.2 trillion in expenses. Department of the Treasury, "Statistics of Income," at 1 (rev. Aug. 2023).

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tax liability of ABC Corp. has not been reduced by 5 percent; it has been reduced by 50 percent. Had legislators been asked, "Should we reduce taxes on multinational corporations by 50 percent to avoid the risks of litigation?" one can imagine many of them saying, "Not today; let's see how the litigation turns out first."

The potential for income distortion in the context of 80/20 companies and subpart F income presages how a lack of conformity to the TCJA will likely lead to even more anomalous state tax outcomes.

Oddly though, it does not appear that tax economists have made a concerted effort to quantify how these conformity choices have affected the state tax liabilities of multinational corporate enterprises. A second understudied component of state policy relating to the TCJA is how the states' apportionment systems should adjust, or not, to the new quasi-territorial system.

IV. Constitutional Limits on State Conformity to The New Federal Quasi-Territorial Tax System

A. The Due Process and Dormant Commerce Clause Principles and International Taxation

The states' hesitancy to fully conform to the TCJA has been affected by continuing uncertainty over the constitutional limitations on state taxing authority potentially affecting foreign commerce. For many states, especially combined filing states, the concerns are not well founded.

Both the commerce clause[22] and the due process clause[23] limit the reach of state taxing authority in two distinct ways.

Both clauses have been interpreted to prohibit states from taxing "extraterritorial values" — that is, states may not tax income generated beyond their borders. To avoid such prohibited taxation, the states use formulary apportionment to appropriately divide the tax base among the jurisdictions in which a taxpayer operates. Getting the apportionment system right is critical to ensuring that the states are taxing domestic entities and multinational entities in a fair and consistent manner.

Second, both clauses prohibit the states from discriminating against either interstate commerce or foreign commerce or those engaged in such commerce. The commerce clause provides in its entirety that "Congress shall have the power to regulate commerce with foreign Nations, among the several States, and with the Indian Tribes."

The Supreme Court has recognized that while the clause addresses only congressional powers, it also acts as an independent, self-executing prohibition on certain state activities affecting commerce. This implicit restriction on state authority to regulate commerce is the so-called dormant aspect of the clause.

The dormant commerce clause has in the past been interpreted to broadly prohibit state taxation of anything even indirectly affecting commerce, but suffice to say by 1977, in *Complete Auto Transit Inc. v. Brady*,[24] the Court had settled on a four-part test for determining whether a tax imposition affecting commerce should be upheld. The Court held that a state tax imposition would be upheld when the tax was:

- levied on activity with a substantial nexus to the taxing state;
- fairly apportioned;
- nondiscriminatory; and
- fairly related to the benefits and protections afforded by the state.

The test continues to be used to this day.

In 1979 in *Japan Lines*,[25] the Court had an opportunity to decide whether the dormant commerce clause applied differently in the context of international commerce. That case struck down a municipality's property tax levied on foreign-owned shipping containers temporarily located within the jurisdiction. The Court held that, in addition to the well-settled rules limiting state taxing authority in the context of interstate commerce:

> When a State seeks to tax the instrumentalities of foreign, rather than of interstate, commerce . . . a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a

[22] U.S. Const. Art. I, section 8, cl. 3.

[23] U.S. Const. Amend. XIV.

[24] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279-280 (1977).

[25] *Japan Lines Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

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> substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice" when regulating commercial relations with foreign governments.[26]

Just four years later, in *Container Corp.*,[27] the Court upheld California's use of mandatory worldwide combined reporting to apportion the worldwide income of a U.S. corporation with foreign subsidiaries. The Court described the history of formulary apportionment and explained why states had chosen that method for measuring the amount of an MNE's income earned within the state. The Court held that even though the federal government and its principal trading partners used arm's-length accounting, the state's use of formulary apportionment did not violate the *Japan Lines*' "one voice" requirement, nor did it present a substantial risk of multiple taxation.

In between those two decisions, in *Mobil Oil*,[28] the Court upheld Vermont's authority under the due process clause to include dividends from foreign subsidiaries and partnerships in the state's apportioned tax base. In its reply brief, the taxpayer asserted for the first time that such income could be taxed only on a worldwide combined reporting basis so that the apportionment factors of the foreign entities would be included in the apportionment formula. The majority in *Mobil* held that the argument had been waived by the failure to raise it earlier. Justice John Paul Stevens dissented, arguing that factor representation for the activities of Mobil Oil's foreign affiliates was a critical requirement for including the income in the tax base.[29] Significantly, no party questioned whether inclusion of the dividend income violated the foreign commerce clause, presumably because Vermont's treatment of the foreign dividends was in conformity with the federal tax system.

Stevens's dissent sparked a flurry of state court litigation over whether "factor representation" should be required as a constitutional matter for states taxing foreign-source income, with most courts answering in the negative.[30]

The implicit question running through these cases was whether amounts received from non-combined subsidiaries actually represented the income of the payer or were better viewed as representing the income of the recipient. In *NCR Corp. v. Comptroller of the Treasury*,[31] Maryland's highest court concluded that factor representation was appropriate to reflect dividends paid from the earnings of foreign subsidiaries but not for royalties and interest received from the same subsidiaries. The remand to allow factor representation can be viewed as suggesting that dividends do represent the earnings of the payer.

The Supreme Court has not addressed the question of factor representation for foreign dividends since it was raised, unsuccessfully, in *Mobil*.

B. *Kraft General Foods Inc. v. Iowa*

There are literally hundreds of Supreme Court cases addressing the twin constitutional prohibitions against extraterritorial state taxation and discriminatory state taxation, but in considering state conformity to the TCJA, one case stands out: *Kraft General Foods*.[32] In that case, the Court concluded that Iowa's conformity to the federal tax code using the separate entity reporting system constituted discrimination against foreign commerce because foreign dividends were subject to tax (on an apportioned basis), while domestic dividends were excluded from the base. *Kraft* has played a critical role in the states' treatment of dividends and subpart F income, yet by its terms, it should have no direct impact on the states' conformity to the TCJA.

[26] *Id.* at 451.

[27] *Container Corp. of America Inc. v. Franchise Tax Board*, 463 U.S. 159 (1983).

[28] *Mobil Oil Co. v. Commissioner of Taxes*, 445 U.S. 425 (1980).

[29] *Id.* at 453-462 (Stevens, J., dissenting).

[30] *See, e.g., NCR Corp. v. Taxation and Revenue Department*, 856 P.2d 982 (N.M. Ct. App. 1993); *NCR Corp. v. Commissioner of Revenue*, 438 N.W.2d 86 (Minn. 1989); *compare AT&T Corp. v. Wisconsin*, 422 N.W.2d 629 (Wis. Ct. App. 1988).

[31] *NCR Corp. v. Comptroller of the Treasury*, 544 A.2d 764 (Md. 1988).

[32] *Kraft General Foods Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992).

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To understand *Kraft*, one must begin by understanding the logic of federal dividend treatment under IRC section 243 as written at the time of the decision. Dividends received by a U.S. corporation from other domestic corporations were subject to deduction on a sliding scale. Dividends from 80-percent-or-more-owned corporations were entitled to a 100 percent deduction; those dividends would likely have been eliminated in any event under federal consolidation rules. Dividends from less-than-80 percent-but-more-than-20-percent-owned domestic corporations were entitled to an 80 percent deduction, while dividends from corporations owned 20 percent or less were entitled to a 70 percent deduction.

Dividends from foreign corporations, on the other hand, were fully subject to tax under IRC section 243 but, as the Court noted, Iowa did not follow the federal allowance of a foreign tax credit to alleviate the possibility of double taxation. The Court noted, meanwhile, that the federal deduction for domestic dividends was also intended to eliminate double taxation, citing a well-known treatise.[33] Because Iowa was a separate entity state and conformed to the federal DRD, corporations doing business there could receive dividends from other domestic corporations without incurring additional tax liability, while corporations receiving dividends from foreign entities were subject to tax on that income.

The Court found that corporations with foreign subsidiaries would always pay more tax than similarly situated taxpayers with only domestic subsidiaries. Relying on the stipulations of the parties, the Court concluded that the receipt of dividends from foreign subsidiaries was "foreign commerce" for purposes of applying the dormant foreign commerce clause. The Court held that the disparate treatment of domestic enterprises and MNEs constituted a form of facial discrimination that violated the foreign commerce clause, even though the disparate treatment did not favor Iowa economic interests generally.

If the Court was concerned that Iowa's inclusion of foreign dividends in the tax base carried with it the potential for extraterritorial taxation, it did not mention it. Instead, the Court took Iowa to task for not following the federal foreign tax crediting regime.[34] Yet not all foreign subsidiary income from which dividends are paid is necessarily subject to foreign tax. A crediting system prevents double taxation, but a crediting system doesn't necessarily prevent extraterritorial taxation, suggesting the Court did not equate the receipt of foreign dividends with taxation of foreign earnings.

In footnote 23 of its decision, the Court clarified that the fault with Iowa's taxing system lay in its failure to follow the federal consolidated reporting regime more closely, holding that it would be "hard-pressed" to find facial discrimination had Iowa used a water's-edge combined reporting regime.[35] The Court noted that under combined reporting, all the income of domestic subsidiaries would have been included in the apportionment formula, together with its factors, while the base would include only the dividends paid by foreign subsidiaries.

The narrow holding of *Kraft* is that the state's disparate treatment of dividends based on their source, resulting in double taxation of foreign but not domestic dividends, violated the foreign commerce clause. The potential for impermissible extraterritorial taxation was never raised.

C. Post-*Kraft* Litigation and the States' Response

The *Kraft* decision surprised taxpayers and taxing agencies alike, and in many states, refund claims based on the exclusion of both foreign dividends and subpart F income followed in short order.

In a series of decisions beginning with *In re Morton Thiokol*,[36] the combined filing states, relying on footnote 23 of the *Kraft* decision, were able to sustain their foreign dividend treatment

[33] *Kraft*, 505 U.S. at 73, citing, Boris Bittker and James Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 5.05 (1987).

[34] *Id.* at 74.

[35] *Id.* at 78, n.23.

[36] *In re Morton Thiokol*, 864 P.2d 1175 (Kan. 1993); *see also Tambrands Inc. v. State Tax Assessor*, 595 A.2d 1039 (Me. 1996); *Caterpillar Inc. v. Commissioner of Revenue*, 568 N.W.2d 695 (Minn. 1997); *Caterpillar Inc. v. New Hampshire Department of Revenue Administration*, 741 A.2d 56 (N.H. 1999); and *Bernard Egan v. State of Florida Department of Revenue*, 769 So.2d 1060 (Fla. Dist. Ct. App. 2000).

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against foreign commerce clause challenges. Notwithstanding those successful court decisions, the uncertainties surrounding the reach of the *Kraft* decision likely accelerated the legislative trend away from taxing foreign dividends and subpart F income.

That trend had begun to emerge much earlier, following the Treasury Department's Worldwide Unitary Taxation Working Group, which was convened in the aftermath of California's victory in *Container Corp. v. Franchise Tax Board*. In the face of threatened federal preemption, the participating states informally agreed to forgo mandatory worldwide combined reporting, allowing taxpayers the option to file using water's-edge reporting. The two areas of disagreement the working group did not resolve were the business community's proposed exclusion of 80/20 companies from the water's-edge return and the states' treatment of foreign dividends.[37]

Then, following the *Kraft* decision, the separate entity states were faced with a choice of eliminating all dividends from the tax base or taxing an equal portion of both domestic and foreign dividends. Most states elected to exclude all dividends.

New Mexico tried a different approach, determining that the discrimination identified in *Kraft* could be eliminated by allowing taxpayers to include a portion of their CFC's factors in the denominator of their apportionment formulas. The method proposed by the state is known as the Detroit formula. Under that formula, the factors of CFCs are included in the apportionment formula based on the ratio between the CFC's net income and dividends paid. (The formula derives its name from a 1978 agreement between the city of Detroit and the Ford Motor Co., a compromise resolving their long-standing dispute over foreign dividend taxation.)[38]

Two taxpayers challenged the retroactive application of the formula, however, arguing that it did not equate to total dividend exclusion since the remedy was less favorable to them than outright exclusion of dividends. The New Mexico Supreme Court agreed, requiring the state to eliminate dividends (and subpart F income) from the tax base for separate entity filers.[39] New Mexico continued to include foreign dividends (and subpart F income) in the tax base for combined filers until 2019, allowing factor representation for CFCs under the Detroit formula.

D. The Constitutionality of Taxing Subpart F Income (and Dividends)

While the TCJA eliminated the taxation of foreign dividends, subpart F income is still included in the federal tax base because of its nature as highly mobile (that is, easily shifted) passive income treated as the U.S. taxpayer's income. The *Kraft* decision never mentions subpart F income, and it is unlikely that the Court would have applied the same analysis to it since there was no domestic equivalent subject to a DRD. Nonetheless, as states moved away from foreign dividend taxation in the wake of *Kraft*, subpart F income was carried along with the tide.

States with combined filing regimes choosing to include subpart F income in the apportioned tax base would have little trouble defending against claims of facial discrimination based on *Kraft*'s footnote 23.

States with separate filing regimes would likely face challenges in court if they chose to tax subpart F income again, although those challenges could not easily be premised on anything written in the *Kraft* decision.

There is a clear path for the separate entity states to head off such challenges, however, by adjusting their apportionment formulas to include a portion of the CFC's factors in the denominators of the apportionment formula, using something like the Detroit method of factor representation previously discussed.[40]

Factor representation eliminates claims of extraterritorial taxation as well as claims of

[37] *See* "The Final Report of Worldwide Unitary Taxation Working Group," at 17-18, 27-28 (1984).

[38] *See* Lynn A. Gandhi, "Rev Your Engines — The Detroit Formula: Time for a Revival?" *State Tax Notes*, Feb. 11, 2019, p. 467.

[39] *Conoco Inc. v. Taxation and Revenue Department*, 931 P.2d 730 (N.M. 1996).

[40] Maine relied on a similar system called the Augusta formula to address concerns over extraterritorial taxation in *E.I. Dupont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996).

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discrimination. It is the appropriate means to apportion the income of an MNE's domestic- and foreign-source income to ensure the state is taxing an appropriate share of income. It is appropriate for combined filing states to consider as well — not to avoid facial discrimination claims, but to ensure that domestic and multinational firms are placed on equal footing.

Factor representation is far more efficacious in apportioning income fairly than the somewhat arbitrary decision to tax a percentage of subpart F income or dividend income, for it avoids underrepresenting or overrepresenting the income attributable to activities in foreign jurisdictions.

Factor representation resolves the lingering concern over dividend taxation voiced by Justice Stevens 44 years ago in his dissenting opinion in *Mobil Oil*.

E. The Constitutionality of Taxing GILTI

Whether the states can include GILTI in their tax base as a constitutional matter is a question that has not yet been addressed by any court, defying the prediction of some tax experts.[41] The absence of reported litigation is presumably attributable to policy decisions in the majority of states to exclude most or all of this income from the tax base, despite the potential effect on the taxable income calculations for multinational corporations. Separate filing states are unlikely to see any GILTI income since it can be reported on the returns of non-nexus subsidiaries included on the taxpayers' federal consolidated returns. Water's-edge filing states that exclude 80/20 companies from the tax base are likely to be similarly affected.

Kraft and its aftermath suggest that the states are not constitutionally restrained from including GILTI in the apportioned tax base, with or without some form of factor representation. *Kraft* held that the disparate treatment of foreign and domestic dividends could not be justified by the state's legitimate interest in conforming to the federal tax code because the state conformity was only partial. Taxpayers who engaged in foreign commerce were systematically disfavored.

The Court has said in a similar context that "a State's tax discriminates only where the State cannot sufficiently justify differences in treatment between similarly situated taxpayers."[42] There is no disparate treatment of those receiving GILTI in combined filing states because all income generated by domestic subsidiaries is included on the combined return.[43]

For separate filing states, there is no equivalent to GILTI that those states allow as a deduction for the extraordinary profits of domestic subsidiaries. And GILTI is computed on a formulaic basis, while the separate entity states use arm's-length accounting to separate the profits of corporations engaged in business in the state from the profits of unitary corporations doing business outside the state. And finally, most separate entity states do have analogous provisions for when arm's-length accounting fails to reflect where intangible income is earned: so-called addback statutes that deny deductions taken for intangible property expenses paid to related parties. In sum, there appears to be no principled basis to make out a claim of facial discrimination based on state taxation of GILTI.[44]

The question remains, however, whether taxation of GILTI constitutes an impermissible taxation of extraterritorial income. Such a finding would run headlong into a century of Supreme Court jurisprudence holding that the states have wide latitude in determining how multijurisdictional income should be apportioned. In *Container*, the Court likened the process of allocating income among competing jurisdictions to "slicing a shadow."[45] The Court has repeatedly held that a taxpayer challenging the constitutionality of a tax based on a claim of extraterritorial taxation has the burden to show, "by 'clear and cogent evidence' that the income

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[41] *See, e.g.*, Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, para. 7.19 ("We can declare without fear of contradiction that these conformity issues will be the focus of future legal controversy.")(updated Dec. 2021).

[42] *Alabama Department of Revenue v. CSX Transportation Inc.*, 575 U.S. 21, 30 (2015).

[43] *Kraft*, 505 U.S. at 78, n.23.

[44] For a far more comprehensive analysis of the *Kraft* decision and its inapplicability to state conformity with the TCJA, see Michael T. Fatale, "Foreign Commerce Clause Discrimination, Revisiting *Kraft* After *Wayfair*," 72 *Baylor L. Rev.* 1 (2020).

[45] *Container Corp.*, 463 U.S. at 192.

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attributed to the State is, in fact, 'out of all appropriate proportions to the business transacted . . . in that State,' or has led to a grossly distorted result."[46]

Arguably, the decision to tax GILTI while leaving ordinary profits of CFCs untaxed suggests Congress has determined that those profits are properly seen as having a U.S. source. The difficult macroeconomic analysis that would be necessary to resolve the question is exactly the kind of inquiry the Court has said should be left to legislative bodies.[47]

There is a second, independent reason why a macroeconomic claim of unconstitutional extraterritorial taxation would likely fail. In enacting the TCJA, Congress clearly aimed to encourage more domestic activity, and nowhere is that more apparent than in the allowance of a deduction under IRC section 250 for the extraordinary profits derived from selling goods and services overseas. Currently, almost every state that includes a significant percentage of GILTI in the tax base also allows the FDII deduction in IRC section 250. To the extent GILTI could be seen as being foreign-derived, low-taxed foreign-source income, the taxation of that income has to be seen in the context of the mirror allowance of a deduction for something called *foreign-derived intangible income*.

The fact that states are not compelled, as a constitutional matter, to make adjustments to the apportionment formula when GILTI is included in the state tax base does not mean they should not investigate whether it is appropriate do so as a matter of tax equity.[48]

F. The Role of Apportionment

The states already have the authority to adjust the apportionment formula on a case-by-case basis in the event of a clear over- or under-taxation of income resulting from conformity to the federal tax base. Every state's taxing regime incorporates some form of the Uniform Division of Income for Tax Purposes Act's alternative apportionment provisions, allowing for the use of "any other method" to achieve a fairer representation of the income derived from activity within the taxing jurisdiction.[49] Such an inquiry would presumably begin with an analysis of the taxpayer's hypothetical liability under a worldwide combined reporting regime.[50] Using worldwide combined reporting as a benchmark for gauging distortion is consistent with the states' long-standing determination to apply formulary apportionment principles to the measurement of in-state income.

The use of alternative means of apportioning income may be necessary to ensure that multinational taxpayers are neither advantaged nor disadvantaged by the intersection of state and federal tax systems. Simply adding some portion of GILTI to the "receipts factor" denominator may not be an appropriate solution, however. The receipts factor in UDITPA is intended to represent the contributions of the marketplace to the generation of income. In many states, the location of sales has been chosen as the sole measure for where income is generated. Adding a portion of GILTI, taxable dividends, or subpart F income to the receipts factor serves only to distort the picture of where sales activity takes place. It is combining two different concepts for measuring income generation, resulting in an inaccurate measure of both.

The problem of mixing two separate concepts for sourcing income is highlighted by the recent decision of the California Office of Tax Appeals (OTA) in *Microsoft*.[51] As in many states, the water's-edge tax base in California includes only a portion of the taxpayer's federally taxed subpart F and dividend income. The reduced inclusion amount acts as a proxy for estimating the taxpayer's hypothetical tax liability under the worldwide combined reporting system. Had the taxpayer filed a worldwide return, the tax base

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[46] *Id.* at 170 (cleaned up).

[47] *See, e.g., Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

[48] One suggestion that has been raised is to include in the states' apportioned tax base an amount of GILTI equal to the federal tax effectively imposed on GILTI, after allowance of the foreign tax credit. *See* Amy Hamilton, "Hecht Proposes Deemed GILTI Base for States," *State Tax Notes*, Apr. 29, 2019, p. 454.

[49] *See* Multistate Tax Compact, Art. IV, section 18.

[50] For additional discussion of the use of worldwide combined reporting as an appropriate response to the TCJA, see Brian Hamer, "States Should Embrace GILTI or Pursue an Alternative Path to Fairness," *State Tax Notes*, Feb. 11, 2019, p. 475.

[51] *Appeal of Microsoft Corp.*, OTA No. 21037336 (Cal. Tax App. July 27, 2023) (currently unpublished).

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would have been greater, but the CFC's apportionment factors would have reduced the California percentage applied to the base. The inclusion amount can thus be seen as an attempt to equal the tax burdens on water's-edge and worldwide combined filers. (Taxpayers who disagree with the math can always elect to file on a worldwide basis.)

But the California apportionment provisions go further, also allowing the taxable dividend amount into the receipts factor denominator.[52] This inclusion distorts the measure of where sales occur, while duplicating the purpose of the partial dividend exclusion.

Microsoft repatriated over $108 billion in deferred earnings under the provisions of IRC section 965(a). Not satisfied with the $26 billion increase in the receipts factor denominator, the taxpayer argued that receipts are a measure of gross sales, not net sales, so an additional $78 billion — the total amount of repatriated income — should go into the receipts factor. The OTA agreed. Increasing the sales factor denominator by $78 billion significantly reduced Microsoft's California apportionment percentage, resulting in a $94 million refund. The OTA rejected the Franchise Tax Board's request for a rehearing to consider the application of alternative apportionment principles.

V. The Path Forward

Six years after the passage of the TCJA, no consensus has been reached in our "laboratories of democracy"[53] on conformity to the provisions of the TCJA, nor has a consensus been reached as to the proper way to apportion the incomes of multinational taxpayers in the new paradigm of (almost) territorial taxation. Not only are the federal numbers too big to ignore, but as previously discussed, in the peculiar world of corporate income taxation, the consequences of simply eliminating a revenue stream from the taxable base are significantly magnified if the expenses associated with that revenue stream aren't eliminated as well.

It seems likely that the states that have chosen to de-conform to GILTI and subpart F income are now taxing multinational firms at a far lower ETR (when measured as a percentage of federal taxable income or book income) than domestic-only firms. That potential favoritism would be especially pronounced in states that also allow the federal deduction for FDII. Multinational firms with exceptionally high intangible property values, such as pharmaceutical companies and technology companies, would appear to be the most likely entities to benefit from the current state of affairs. Those entities are more likely to have a higher percentage of their federal incomes taxed as GILTI and would presumably have more easily shifted passive income currently reported under the subpart F rules.[54]

It may be that state legislatures intended to favor multinational business enterprises, or it may be that the consequences of nonconformity to the TCJA were not entirely understood. The states now have in their possession several years of tax returns that can be compared with federal returns and publicly reported profit figures to begin the process of evaluating if changes to state corporate tax statutes and policies are warranted. ■

[52] Cal. Rev. & Tax. Code section 25120(f)(2).

[53] *New State Ice Co. v. Liebmann*, 285 U.S. 262, 272 (1932) (Brandeis, J., dissenting).

[54] One surefire method to ensure that those engaged in domestic and foreign commerce are treated equally by state tax impositions is the adoption of mandatory worldwide combined reporting, but that solution does not appear to have political support in any state now.

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