



## **Briefing Book**

# **Changes in Federal Taxation of Multinational Corporate Groups**

**How these changes will affect state corporate taxes  
and state policy choices.**

**Prepared by the  
Staff of the Multistate Tax Commission  
March 13, 2026**

**This briefing book may be updated as additional information or  
state input becomes available.**

## Preface and Important Note

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### **The MTC**

The Multistate Tax Commission (MTC) is a state government instrumentality formed in 1967 to administer the Multistate Tax Compact, an agreement among participating states to provide a more uniform system for dividing the income of multijurisdictional businesses.<sup>1</sup>

The purposes of the Compact are:

- Facilitating the proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
- Promoting uniformity or compatibility in significant components of tax systems;
- Facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and
- Avoiding duplicative taxation.<sup>2</sup>

### **Reason for this Briefing Book**

Throughout its existence, the MTC has focused on developing and improving the system under which states determine their fair share of the income of multistate businesses. That system uses formulary apportionment of net income, applying a ratio of certain quantifiable factors, such as sales or receipts, within that state.

The federal government and its foreign trading partners have adopted far different systems for taxing the income of multinational enterprises. And states generally conform to the federal computation of domestic taxable income. For this reason, states rely on the federal system to determine the domestic share of income of multinational enterprises that they, in turn, apportion.

The purpose of this briefing book is to help our members understand the interplay of these two systems and their effects on state taxation of multinational enterprises, including the effects of recent changes to the federal and international tax systems.

### **Important Note**

This briefing book was prepared by MTC staff on behalf of its members and participating states. It contains summaries of generally applicable tax concepts as well as more detailed information and resources related to the issues covered. Unless otherwise noted, any conclusions contained in this briefing book do not represent the official positions of the MTC or its members.

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<sup>1</sup> See the MTC website, here: <https://www.mtc.gov/>.

<sup>2</sup> Multistate Tax Compact, Art. I., available here: <https://www.mtc.gov/the-commission/multistate-tax-compact/>.

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## Introduction: Briefing Book Sections & Important Terms

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This briefing book addresses recent changes to the federal tax treatment of multinational corporate enterprises, which will affect all states that impose corporate income taxes. There is a lot of interrelated information that may be useful to different states, so this information is organized as follows:

**Section I – Context:** The effects of recent federal changes can best be understood in the larger context of how the state and federal tax systems generally work and relate to each other.

**Section II – Federal System’s Shift from Transfer Pricing to Attribution:** This section traces the history of the shift in the federal system from transfer pricing to attribution and the describes the problems with transfer pricing that prompted this shift.

**Section III – Important State Tax History – Foreign Dividends, Subpart F Income & “80/20” Companies:** This section summarizes how state tax systems have generally treated foreign income, particularly foreign dividends, subpart F income, and the use of 80/20 rules to determine the tax base of water’s edge filing group.

**Section IV – State Conformity, Options and Alternative:** This section provides possible options available to state policymakers for adapting their tax systems going forward, including conforming to the new federal system or requiring mandatory worldwide combined filing.

**Note: Common abbreviations used in this briefing book include:**

- TCJA = 2017 Tax Cuts and Jobs Act
- OB3 = 2025 One Big Beautiful Bill Act
- MNE = Multinational enterprise
- HTJ = High-tax jurisdiction
- LTJ = Low-tax jurisdiction
- WWCR = Worldwide combined reporting
- FTC = Foreign tax credit
- UDITPA = Uniform Division of Income for Tax Purposes Act

## I. Context

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This section provides necessary context and key concepts that are part of any corporate income tax system. In application, these concepts can be complex. To facilitate this summary, certain exceptions or details that are generally not relevant for the topics covered are omitted.

### **State Conformity to Federal Calculation of Taxable Income**

When calculating net taxable income, states generally conform to the federal income tax rules for determining the character and treatment of various items of income, expense, gain, and loss. Each state may conform to the federal rules somewhat differently and may decouple from certain provisions. This general conformity to the federal computation of net taxable income does not apply to other elements of the federal tax system—including tax rates and certain types of incentives. Most importantly, states have taken somewhat different approaches to three key questions, summarized here.

### **Key Questions for Taxing Multinational Corporate Groups**

Taxing income of multinational corporate groups, sometimes referred to as multinational enterprises (MNEs), requires solving three key questions. In response to these three questions, the federal and state systems evolved emphasizing somewhat different approaches that shaped how each tax system works structurally. While these approaches are summarized separately here, they often co-exist and interact within each tax system.

#### **Taxing Jurisdiction –**

*When can tax be imposed on income of a non-domiciliary entity?*

##### **Approaches to this Question:**

- Traditional physical presence standards applied to each entity.  
Jurisdiction exists if the entity has a physical presence, sometimes referred to as a “permanent establishment,” and the income is related to that presence.
- Economic presence standards applied to the “unitary” group.  
Jurisdiction exists if the entity has an economic presence—generally characterized by activities related to making a market—and extends to all related entities engaged in a unitary business.

##### **Differences and Implications:**

- Federal system – traditional physical presence standards.  
The federal and international tax systems were primarily built based on this approach, which limits the potential aggregation of the incomes of a corporate group to those realized by entities meeting the physical presence standard, regardless of economic integration. As a result, other approaches must be utilized to address income shifting from inter-company transactions and cost sharing arrangements (discussed further below).

- State system – economic presence of the unitary group.

The states' taxing systems have long recognized that the income of entities engaging in a "unitary" business may be subject to tax based on the economic presence of that business in the state.<sup>3</sup> As discussed further below, the economic presence standard supports the use of aggregation of incomes, even for MNEs. This is true for worldwide groups as well, see *Barclays Bank*.<sup>4</sup>

## **Intercompany Transactions and Cost-Sharing:**

*How are intercompany transactions and shared costs of corporate groups treated so as to avoid the shifting of income to low tax jurisdictions?*

### **Approaches to this Question:**

- Aggregating the incomes and expenses of the group.

The aggregation of incomes and expenses of related entities to compute a single net income amount is the simplest approach, and the only one that completely eliminates the effects of intercompany transactions and shared costs.

- Using transfer pricing rules to determine each entity's separate income.

To enable the computation of separate net income by entity, intercompany transactions and shared costs are valued and characterized based on the arm's length standard for each affected entity as if they were not related.

- Attributing income or expense recognized by an entity to its parent.

Particular items or amounts of income or expense earned or incurred by one entity are attributed to its parent. The attribution can also affect sourcing (see below).

- Applying add-back rules for certain intercompany expenses.

Deductions for certain intercompany expenses may be denied unless the related income is recognized and taxed in another jurisdiction.

### **Differences and Implications:**

- Federal system – domestic aggregation with transfer pricing and attribution.

The federal system allows consolidated filing only for domestic entities (with 80% or more common control). Foreign entities with domestic income that meet traditional jurisdictional standards, discussed above, are required to file separate federal returns. Historically, the federal system has relied on transfer pricing rules to determine the tax base for each return. More recently, the federal system has used attribution to address the effects

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<sup>3</sup> See the MTC's Factor Presence Nexus Standard, here: <https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/Factor-Presence.pdf>; and here: <https://www.mtc.gov/wp-content/uploads/2022/12/2022-Resolution-Factor-Presence.pdf>.

<sup>4</sup> *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994).

of the intercompany transactions and shared costs of multinational groups in recognition of the limitations of transfer pricing valuations.

- State systems – varies.

Today a minority of states permit separate corporate filing and rely entirely on federal transfer pricing rules and state add-back provisions. But most states take the following approach:

- Aggregation (combination) of income of certain entities in a unitary group.

States have authority to aggregate income of multinational groups, including any foreign entities, to the extent that income is part of the same unitary business.<sup>5</sup> (When combining related entities' income and factors, states generally use a 50% common control standard.) Although the U.S. Supreme Court upheld the states' authority to require worldwide combined reporting (WWCR), the states informally agreed to repeal such filing requirements in the 1980's under pressure from U.S. foreign trading partners.<sup>6</sup> While both the state and federal systems limit the use of aggregation, the make-up of the consolidated and combined groups may differ. Some states also allow filing on a federal consolidated basis.<sup>7</sup>

- Federal transfer pricing and attribution rules.

In the absence of mandatory worldwide combined reporting (WWCR) requirements, states effectively rely on the federal tax system's use of transfer pricing rules and attribution to determine the tax base of domestic entities that are part of a multinational group. States also rely on transfer pricing rules in situations where the state filing group differs from the federal consolidated group.

- Add-back provisions.

Some combined filing states may also use add-back provisions which deny certain deductions arising from transactions with related domestic and foreign entities.<sup>8</sup>

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<sup>5</sup> Id.

<sup>6</sup> See The Chairman's Report on the Worldwide Unitary Taxation Working Group, Activities, Issues, and Recommendations, Office of the Sec. of the Treasury, July 1984, available here: [https://upload.wikimedia.org/wikipedia/commons/8/85/The\\_chairman%27s\\_report\\_on\\_the\\_Worldwide\\_Unitary\\_Taxation\\_Working\\_Group\\_-\\_activities%2C\\_issues%2C\\_and\\_recommendations\\_%281A\\_chairmansreporto00unit%29.pdf](https://upload.wikimedia.org/wikipedia/commons/8/85/The_chairman%27s_report_on_the_Worldwide_Unitary_Taxation_Working_Group_-_activities%2C_issues%2C_and_recommendations_%281A_chairmansreporto00unit%29.pdf).

<sup>7</sup> The MTC has adopted two models for combined filing that use a default worldwide filing approach to the combining of multinational corporate groups, but both models also allow a water's-edge election. See those models on the MTC website, here: <https://www.mtc.gov/uniformity/adopted-uniformity-recommendations/>.

<sup>8</sup> See the MTC's model add-back statute here: <https://www.mtc.gov/wp-content/uploads/2023/02/Add-Back-FINAL-version.pdf>.

## **Sourcing Multijurisdictional Income:**

*What sourcing methods are used in determining a jurisdiction's share of total income?*

### **Approaches to this Question:**

- Source to domicile.  
Income is sourced 100% to an entity's domicile.
- Source using rules of assignment.  
Items of income along with direct expense are sourced based on specific rules of assignment; indirect expenses are then apportioned pro-rata.
- Hybrid method – domicile plus rules of assignment with a credit for taxes paid.  
Income of domestic entities is sourced 100% to domicile while income of nondomiciliary entities is sourced using rules of assignment. A credit is provided to domestic entities for taxes paid to other jurisdictions.
- Apportionment of net income.  
Items of income and expense are netted and the net amount is apportioned using a formula that looks to the share of certain corporate activity—often the share of receipts from transactions—taking place in the jurisdiction.

### **Differences and Implications:**

The jurisdictional standards and treatment of intercompany transactions and shared costs, discussed above, do not necessarily dictate the approaches used to source income. That said, combining traditional jurisdictional standards with the use of apportionment to source income can lead to “nowhere” income—where income is sourced to no location or to a location that lacks jurisdiction.

- Federal system – hybrid method.  
The federal international tax system generally treats income of domestic entities as 100% taxable with a credit for foreign taxes paid, provided that income was sourced to the taxing jurisdiction appropriately. An important aspect of this credit system is that it offsets federal tax only to the extent tax was paid. Income of foreign entities or groups is sourced using rules of assignment subject to jurisdictional limitations. One exception is where income of a foreign entity within a group is attributed to a domestic entity.
- State system – apportionment of net income with assignment of certain items.  
The state system uses formulary apportionment, which may be applied to the income of a corporate group or to separate entities, including foreign entities required to file within that state. The state system uses rules of assignment only for limited purposes, including when a particular item of income or expense is not part of the unitary business subject to apportionment. Today, most states use an apportionment formula based on the ratio of the corporation's or group's receipts assigned to the state over its total receipts. So, unlike the federal system, there is no need to provide credits for other state or foreign taxes paid.

Note that this last point—that states do not need to provide credits for taxes paid when they impose tax on an apportioned basis—may seem obvious. Nevertheless, the argument has been made that states that wish to include in their tax base the amount of net CFC tested income of the parent (conforming to IRC § 951A under the OB3) cannot simply provide factor representation (the inclusion of related foreign factors in the apportionment formula) as they would when apportioning domestic income, but must also provide credits for foreign taxes paid. Otherwise, the argument concludes, the states will be subjecting “foreign income” to “multiple taxes.”<sup>9</sup>

This argument simply has no basis. When states fairly apportion multistate or multinational income, they are not taxing income earned outside their borders, even if the income is sourced differently and taxed by other states or foreign countries. See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). Therefore, states do not need to provide credits for these other taxes paid.

### **Important Additional Implication — Taxation of Foreign Dividends**

The different approaches used for taxing multinational corporate groups affects the treatment of dividends paid. Where aggregation is used to consolidate or combine the income of subsidiaries with the parent’s income, any dividends received from those subsidiaries would typically be excluded. When the subsidiaries’ income is not aggregated with or attributed to the parent, including the dividends paid in the tax base is a means of taxing the parent’s share of that income, albeit on a deferred basis (with or without credits for taxes paid to other jurisdictions).

The federal treatment of foreign dividends and the recent changes to this treatment are discussed further in the following sections. This issue is especially important to states because of the history surrounding the state taxation of foreign dividends, discussed in Section III.

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<sup>9</sup> This argument was made by the Council on State Taxation (COST) in a letter submitted to the governor of New Mexico with regard to recently enacted legislation, Senate Bill 151, which includes NCTI in the tax base of the parent (group) subject to the rules for sourcing corporate income which are based on the allocation and apportionment rules of UDITPA. See that legislation, available here: <https://www.nmlegis.gov/Legislation/Legislation?Chamber=S&LegType=B&LegNo=151&year=26>.

## II. Federal System’s Shift from Transfer Pricing to Attribution

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This section reviews how the traditional federal tax system has changed and summarizes the important international provisions of the 2017 Tax Cuts and Jobs Act (TCJA) and the 2025 One Big Beautiful Bill Act (OB3). These changes were driven in large part by the perceived failure of the transfer pricing rules to prevent international income shifting. We describe how these changes are likely to affect federal transfer pricing adjustments in the future.

### Pre-1962 Treatment of MNEs Under the Federal Tax System

As summarized in Section I, the federal system recognizes the formalism of separate legal entities and their domicile, as well as the traditional (narrow) standards for tax jurisdiction. This system reflects traditional rules for doing business in other countries which may require foreign businesses to form local entities subject to local rules. As a result, the federal system has generally provided for aggregation (consolidation) of income only with respect to domestic entities of a corporate group. It has also used a hybrid system for taxing the income of these MNEs:

- Foreign Corporations – No tax imposed on income recognized by foreign entities unless that income is effectively connected to a permanent establishment in the U.S.
- Domestic Corporations – Tax imposed on worldwide income of domestic entities, including “outbound” transactions or activities (that is, transactions directed toward foreign jurisdictions), and on dividends or distributions received from foreign subsidiaries (see IRC Secs. 316 and 317), offset by a credit for foreign taxes paid, if any.

Because of local rules and this hybrid system, U.S. based MNEs have typically conducted foreign operations through separate foreign entities. Doing so allowed MNEs to shift income to affiliates in low-tax jurisdictions (LTJs) by controlling the transfer prices of intercompany transactions and cost-sharing arrangements. Domestic MNEs could then defer any U.S. tax on that income while still controlling how those foreign subsidiaries use their income.

### 1962 – Adoption of Attribution for Passive Subpart F Income

In 1962, Congress recognized that the problems of income shifting and deferral were especially pervasive where the foreign income took the form of passive investment income.<sup>10</sup> To address this problem, Congress enacted IRC subpart F which attributes certain passive income earned by controlled foreign corporations (CFCs)<sup>11</sup> to the domestic shareholders, according to their interest in the CFC.<sup>12</sup> The treatment of passive subpart F income continues under the current federal

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<sup>10</sup> A crude example is where a domestic entity borrows money from a foreign affiliate located in a low-tax jurisdiction (LTJ), then invests the borrowed funds, earning income which is offset by the interest paid to the foreign affiliate. The interest income of that affiliate would then remain in the LTJ indefinitely, being reinvested by that affiliate out of reach of U.S. jurisdiction.

<sup>11</sup> IRC Sec. 957(a) defines controlled foreign corporations as corporations with more than 50% of the value of their shares or total voting powers controlled by a U.S. shareholder.

<sup>12</sup> Here is a quote from President Kennedy’s tax message to the Committee on Ways and Means about the toll deferral of income was taking on U.S. corporate taxation and a proposal that would become subpart F: *“The reductions in tax that can be achieved through the use of tax haven operations assume that the incomes attributed to the tax haven companies are fair and reasonable. But the problem [of deferral] is compounded by the fact that incomes are often allocated to tax haven companies which are not economically justifiable. U.S. companies frequently attribute a disproportionate share of profits to the trading, licensing, and*

system, applicable to both corporate and individual shareholders who hold a voting interest in a CFC of at least 10%. See IRC Sec. 951(b). The effectiveness of subpart F income rules has been limited to a degree by subsequent regulations and the use of hybrid entities. But, apart from this treatment, the federal system continued to rely on transfer pricing adjustments.

## **Growing Problems with Transfer Pricing**

To understand the weight that has been put on international transfer pricing, it is important to understand the ways in which MNEs exploit the international tax system to shift income.

### **Inconsistencies Between Taxing Jurisdictions and Treaty Shopping**

The biggest inconsistency between taxing jurisdictions is of course the extent to which corporate income is calculated and the effective tax rates applied. Some jurisdictions impose much higher corporate tax rates than others. But other inconsistencies in the tax systems of different jurisdictions may create further opportunities to change the treatment of income or provide additional ways to shift it from high-tax jurisdictions (HTJs) to low-tax jurisdictions (LTJs).

Take, for example, the federal “check-the-box” regulation, Treas. Reg. 301.7701, which determines how certain entities will be treated for tax purposes. This federal regulation—which allows some taxpayers to elect how they wish to be taxed, either as corporations, partnerships, or disregarded entities—appears reasonable and consistent with the kinds of entities created under state law. But the effects of this entity-classification for U.S. tax purposes ends at the U.S. border. Other countries have their own tax rules, including rules for classification of entities. An entity may be treated as a separate entity in some countries, including the one in which it is domiciled, but disregarded under federal rules. These so-called “hybrid” entities have been instrumental in circumventing tax haven classification and anti-abuse rules such as the long-standing attribution of passive income under subpart F discussed above. (See IRC Sec. 245A(e).)

Another layer of opportunity for corporations seeking to shift income has been the network of hundreds of bilateral treaties that affect the tax imposed on MNEs. Although many of these treaties follow the international model, each has been separately negotiated and often contains idiosyncratic provisions. Corporations in HTJs have created entities to obtain the benefit of a specific treaty and then use complex financial instruments to shift income to LTJs.

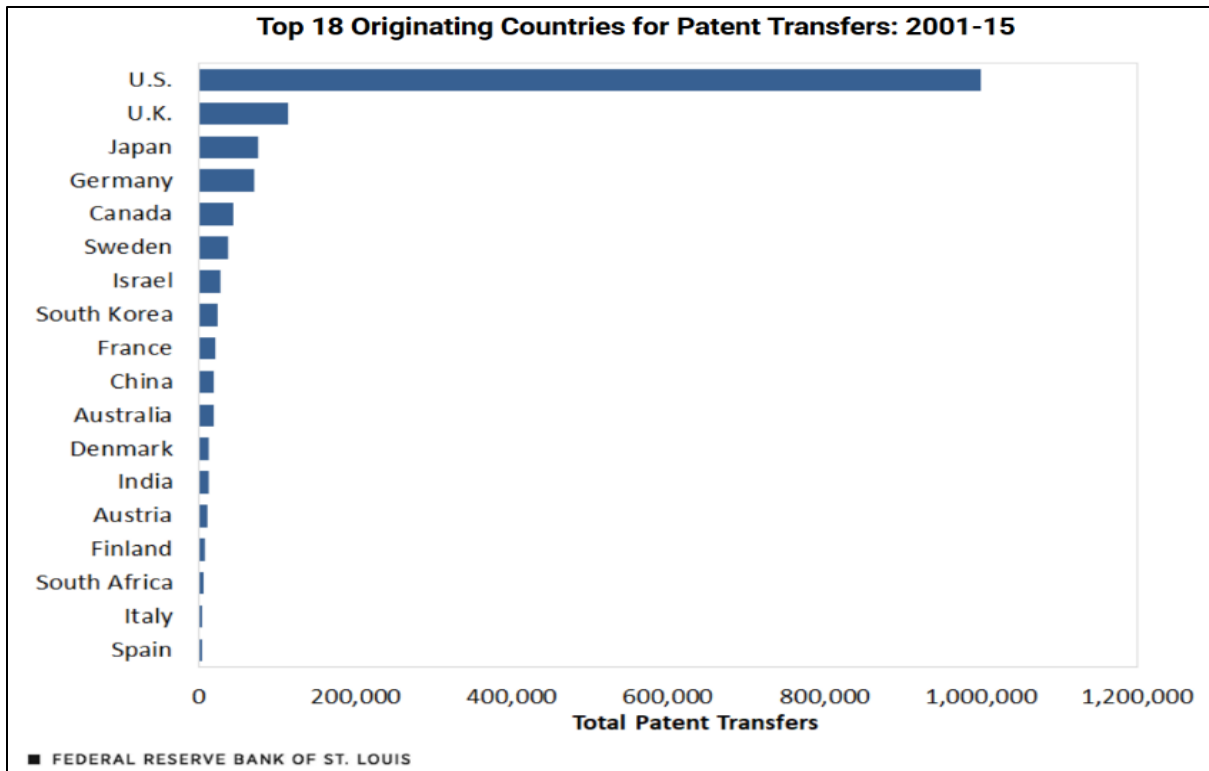
### **Growing Value of Easy-to-Shift Intangible Property**

Today, not only can MNEs conduct international business operations much more easily than in decades past, but the value they build is more likely to be captured in the form of intangible assets such as patents, trademarks, copyrights, goodwill, etc. These assets, unlike many valuable assets of the past, are easy to “move” to another jurisdiction, simply by

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*servicing companies established in tax haven countries—a practice that is extremely difficult if not impossible for the Internal Revenue Service to police effectively.”*

conveying ownership. This then enables foreign subsidiaries to charge royalties or fees to other entities in the group. This issue has especially affected the U.S. tax system.<sup>13</sup>



### **Reliance on Transfer Pricing Rules**

Income shifting schemes have been used by taxpayers from the moment there was an income tax. The idea is simple. A business located in one or more HTJs creates distinct but related entities located in LTJs, typically transferring assets to those entities for less than their value. These entities then levy intercompany charges for activities or transactions with other entities in the group, thus effectively shifting income to the LTJs.<sup>14</sup>

From the beginning, Congress recognized this problem, enacting the first statute to address the potential for abuse in 1928,<sup>15</sup> which after several changes became the current

<sup>13</sup> See Mickenzie Bass , Ana Maria Santacreu , Jesse LaBelle, “Profit Shifting in the 21st Century: Multinationals’ Use of Intrafirm Patent Transfers,” Fed. Res. Bank of St Louis, Sept. 12, 2023, available here: <https://www.stlouisfed.org/on-the-economy/2023/sep/profit-shifting-multinational-use-intrafirm-patent-transfers>.

<sup>14</sup> A landmark case involving the Vestey Group in early 20th century illustrates how this tax avoidance technique works. The group owned multiple corporations in multiple countries. It was vertically integrated to control each step of meat supply to the UK. Among other assets, the group owned slaughterhouses in Argentina. Meat was bought by a trust located in Paris that acted like an offshore entity receiving advantageous tax treatment in France, and then sold above market price to Union Butcher Shop, another entity owned by Vestey Group located in the UK. To add insult to injury, Union Cold Storage also paid above market rent to the Parisian trust. That scheme resulted in nearly all profit remaining in the Parisian trust which received advantageous tax treatment in France at the time.

<sup>15</sup> SEC. 45 (1928). ALLOCATION OF INCOME AND DEDUCTIONS. In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions

IRC Sec. 482. Under Sec. 482, the IRS has authority to reallocate tax items, including gross income, deductions, credits, or allowances between related entities to clearly reflect the net income of each entity. In theory, this allows the IRS to correct the valuation of controlled transactions, in large part by matching them with the price of comparable uncontrolled transactions. This is transfer pricing using the arm's-length standard (See Treas. Reg. 1.482-1(b)(1)).

### **The Faulty Premise of an Arm's-Length Price**

Financial accounting rules generally require the consolidation of the financial results of a controlled group of entities.<sup>16</sup> Why? Because these rules are built on the recognition that it is only when there is an exchange between unrelated parties that the true value of many things can be clearly determined. Despite this reality, the federal and international tax systems have attempted to determine when transactions between related entities have occurred and then value those transactions (or attribute shared costs) to each entity using “arm's-length” pricing.

In theory, there are multiple methods for determining whether a transaction is valued on an arm's-length basis. Treasury regulations offer several methods to choose from, as do OECD guidelines. And while federal regulations provide a rule for choosing which method is most reliable based on facts and circumstances (see Treas. Reg. 1.482-8(a)), these same regulations acknowledge that this test must be applied somewhat flexibly since identical uncontrolled transactions—especially those involving transfers of intangible property—are nearly impossible to find. This is because vertically integrated groups add a certain amount of intangible value to any transaction, whether it is from economies of scale, shared know-how, financial leverage, brand names, or other specific intellectual property.

As the economy has become highly dependent on intellectual property, with intangible assets representing \$80 trillion of global corporate assets,<sup>17</sup> the problem of valuation has become increasingly difficult.

### **Example – the Facebook Case.**

The recent *Facebook* case illustrates the difficulty of valuing intercompany transactions involving intellectual property (IP), and how, ironically, that determination may depend on an apportionment of future receipts. The case focuses on Treas. Reg. 1.482-7T and its use of cost-sharing agreements. A cost-sharing agreement (CSA) aggregates transactions among entities of the same controlled group, allocating development costs between entities. CSAs are used for the development of new IP.

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between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses.

<sup>16</sup> See FASB Statement Nos. 141 and 160.

<sup>17</sup> World Intellectual Property Organization (WIPO) tracks data on the value of intangible assets available on their website, here: <https://www.wipo.int/en/web/global-innovation-index/w/blogs/2025/the-value-of-intangible-assets-of-corporations#:~:text=There%20is%20significant%20variation%20in,rallies%20observed%20in%20Western%20economies.>

Such development is generally built on pre-existing IP, however. In this case, that pre-existing IP was the Facebook platform. Where a platform is part of the assets contributed, the regulations require the transferring entity to recognize income commensurate with the expected profits attributable to the transfer of the intangible property, called a platform contribution transaction (PCT). The arm's-length value of this payment is the focus of the *Facebook* case.

To approximate the arm's-length value, the IRS applied the so-called "income method," which uses a discounted future cash flow analysis based on a realistic alternative involving an independent third party. The IRS valued the contribution at \$19.95 billion while Facebook estimated it at only \$6.3 billion. Fifteen years after the initial CSA was entered into, the tax court held that it was appropriate to apply the income method to determine the value of the PCT. While this was a win for the IRS, the court also held that the valuation the IRS used was unreasonable and determined a valuation closer to the taxpayer's estimate.<sup>18</sup>

This case illustrates the core problems with transfer pricing arm's-length analysis:

- The scale of the difference in valuation even applying *the same method* demonstrates that finding a single, realistic arm's-length price is often impossible.
- Even when the purported transaction appears to lack economic substance, the rules ask for the use of a fictional transaction. Complex value chains, or unique intangibles with no real equivalent, lead to a battle of experts.
- The administrative burden for businesses and tax administrators is high. Indeed, transfer pricing is its own industry, employing thousands of professionals and experts in the U.S. alone. Litigation is often the only way to resolve these disputes, and like the *Facebook* case, it may take years to resolve.
- Finally, the time it takes to resolve issues is not just a burden in terms of cost, but also means that current issues are often left un-addressed as facts and circumstances change. And while the *Facebook* case does not raise the issue directly, questions remain as to whether periodic payments between related parties should be adjusted over time as new information affects values.

In sum, the trouble with relying on transfer pricing and the arm's-length principle is that it is based on a premise that was never very sound and has become less so in the century since it was first adopted. Indeed, it was this reality that led the Supreme Court to approve the states' use of combined filing and apportionment in the face of challenges from MNEs arguing that this approach taxed the income of entities having no presence in the state.<sup>19</sup>

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<sup>18</sup> *Facebook, Inc. & Subsidiaries v. Commissioner of Internal Revenue*, U.S. Tax Court Docket No. 21959-16, May 22, 2025.

<sup>19</sup> See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

## 2017 - TCJA Expands Attribution with Targeted Effective Tax Rates

The federal system for taxing MNEs began to change in 2017 when the TCJA expanded the attribution of income from CFCs to U.S. shareholders under subpart F to address income shifting, along with related provisions to create certain targeted effective tax rates on “outbound” transactions of MNEs.

In addition to income shifting, Congress was concerned that the relatively high corporate income tax rate of 35% disadvantaged U.S.-based MNEs and encouraged inversions (merging with a foreign entity in order to change the domicile of U.S. corporations). To address these issues, the TCJA:

- Reduced the general corporate tax rate to 21%.
- Removed the tax on dividends paid by CFCs (IRC Sec. 245A) while imposing a one-time repatriation tax under IRC Sec. 965 on the accumulated foreign income of CFCs with an offsetting credit for taxes paid.
- Expanded attribution under subpart F to include certain net CFC income, when recognized, in the income of the U.S. shareholder (both individuals and corporations),<sup>20</sup> with provisions to achieve a targeted effective tax rate for that income as follows:
  - First – “net CFC tested income” (the parent’s share of their CFCs aggregate income in the tax year, computed using federal tax rules) was included in the shareholder or parent’s income to the extent it exceeds a 10% return on the CFC’s tangible assets (the so-called “qualified business asset investment” or QBAI reduction), excluding net tested losses. This amount was referred to as “global intangible low taxed income” (GILTI) as it was deemed to be the profits from intangible assets. TCJA IRC Sec. 951A.<sup>21</sup>
  - Second – to achieve a targeted 13.125% effective corporate tax rate on GILTI, a 50% special deduction (IRC Sec. 250(a)(1)(B)) was allowed for corporate shareholders along with a foreign tax credit (FTC) equal to 80% of tax paid (with a gross-up amount under IRC Sec. 78).<sup>22</sup>
- Included new provisions intended to achieve the same 13.125% effective federal corporate tax rate on income from outbound (export) activities of domestic entities as follows:
  - First - outbound income, known as “foreign-derived intangible income” (FDII), is computed and reduced by the same QBAI amount as GILTI.
  - Second – to achieve the same targeted effective corporate tax rate of 13.125% on this income, a 37.5% special deduction was allowed. (IRC Sec. 250(a)(1)(A)).<sup>23</sup>

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<sup>20</sup> This briefing book is concerned with the effect on corporate income tax and income that flows up to corporations.

<sup>21</sup> Note that the IRS issued regulations under the TCJA making an exception for income of CFCs from certain “high tax” jurisdictions—that is, those in which the tax was greater than 90% of the federal 21% tax rate, or 18.9%. This exception, which had to be elected by the domestic parent, meant that neither the income nor the tax paid were included in GILTI or the related FTC.

<sup>22</sup> The standard tax rate of 21% times the amount taxed after the 50% special deduction divided by the 80% FTC offset = 13.125%.

<sup>23</sup> The standard tax rate of 21% times the amount taxed after the 37.5% special deduction = 13.125%.

TCJA also enacted the so called “Base Erosion and Anti-Abuse Tax” (BEAT), which does not affect states directly. It acts as a top-off tax for domestic corporations when they engage in abusive transactions with related foreign entities.

## 2019 – OECD and the BEPS Project

While the federal tax system shifted from transfer pricing to attribution, the Organisation for Economic Co-operation and Development (OECD) also began to grapple with transfer pricing and its inability to address income shifting. Under its Base Erosion and Profit Shifting initiative, the OECD proposed that countries agree to levy a 15% global minimum tax whenever the income of a foreign-based MNE has not been taxed at that minimum level by its country of domicile.<sup>24</sup>

## 2025 – OB3 Continues the Trend from Transfer Pricing to Attribution

In 2025, Congress continued the use of attribution and expanded the amounts included by:

- Changing the net CFC tested income calculation under IRC Sec. 904(b)(5), most notably by reducing certain expenses allocable to NCTI like interest and research expenses and re-allocating them instead to U.S. sourced income. This change should reduce the number of U.S. MNEs electing to exclude CFCs from HTJs on which such deductions were previously “wasted”.<sup>25</sup>
- Eliminating the QBAI reduction from both GILTI (now simply the “net CFC tested income,” or NCTI) and FDII (now “foreign-derived deduction eligible income,” or FDDEI). This was done to reduce the incentive for U.S. corporations to move tangible assets abroad in order to increase the QBAI reduction amount.
- Changing the special deduction for NCTI under IRC Sec. 250(a)(1)(B) from 50% to 40% and the allowable FTC from 80% to 90% to achieve a targeted effective corporate tax rate of 14%.<sup>26</sup>
- Changing the IRC Sec. 250(a)(1)(A) special deduction for FDDEI from 37.5% to 33.34% to achieve the same targeted effective corporate tax rate of 14%.<sup>27</sup>

As of the writing of this briefing book, it appears the NCTI approach has been approved for “side-by-side” treatment under the OECD’s minimum tax requirement.<sup>28</sup> This will effectively protect U.S. MNEs from being subject to minimum tax in other countries.

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<sup>24</sup> See the OECD’s 2013 report on the subject, here: [https://www.oecd.org/en/publications/2013/07/action-plan-on-base-erosion-and-profit-shifting\\_g1g30e67.html](https://www.oecd.org/en/publications/2013/07/action-plan-on-base-erosion-and-profit-shifting_g1g30e67.html).

<sup>25</sup> Supra footnote 19. Note that some MNEs may still elect to exclude from NCTI the CFC income from high tax jurisdictions because overhead expenses related to the production of foreign income and the IRC Secs. 250 deductions must be allocated against foreign income to calculate the FTC limitation.

<sup>26</sup> The standard rate of 21% times the amount taxed after the 40% special deduction divided by the 90% FTC offset = 14%.

<sup>27</sup> The standard rate of 21% times the amount taxed after the 33.34% special deduction = 14%.

<sup>28</sup> See here: <https://www.oecd.org/en/about/news/press-releases/2025/12/international-community-agrees-way-forward-on-global-minimum-tax-package.html>.

## The Likely Effects on Income Shifting

As noted above, transfer pricing rules have become inordinately expensive to enforce and burdensome to comply with. The new attribution method adopted by TCJA and OB3 does not fix this system, but instead largely replaces it. This new structure also imposes substantially lower effective corporate tax rates on both NCTI and FDDEI. U.S. corporations are likely to reorganize themselves to take advantage of this new system.<sup>29</sup> The IRS is likely to substantially reduce its efforts in enforcing transfer pricing rules and instead focus compliance with the new attribution system. This has important implications for states that are still relying on the old transfer pricing rules to ensure that domestic income is not shifted abroad.

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<sup>29</sup> Here is a quote from the IRS LB&I Concept Unit about the IRC Secs. 250 deductions: “*The section 250 deduction helps neutralize the role that tax considerations play when a domestic corporation chooses the location of intangible income attributable to foreign-market activity, that is, whether to earn such income through its controlled foreign corporations (CFCs) or through its U.S.-based operations.*”

## **III. Important State Tax History – Foreign Dividends, Subpart F Income, and “80/20” Companies**

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The new federal international provisions should prompt the states to reconsider their current policies concerning the taxation of MNEs including the treatment of foreign dividends, passive subpart F income, and the scope of any permissible filing groups. To understand how current state policies may hinder the equitable taxation of MNEs by limiting the ability to conform to the new federal system, it is helpful to review the history of how states came to adopt them.

### **Interaction of Conformity, Transfer Pricing, Combination, and Attribution**

As noted in Section I, certain elements of tax systems determine how corporate groups, including MNEs are taxed. This Section III explains how these basic elements interact.

#### **Conformity**

States generally conform to the federal treatment of items going into the computation of net income. This means that state rules often start with a reference to the amount of federal income properly reported (Line 28 or 30 of federal Form 1120), and list any additions or subtractions. As a consequence of calculating state income based on federal taxable income, foreign entities are generally not subject to tax unless those entities are required to file a federal return.

#### **Transfer Pricing**

Federal net income is first calculated on a separate entity basis. Therefore, the results of applying federal transfer pricing rules are “built in” to the net income of entities that are part of a corporate group. This is true for transactions between domestic and foreign entities. In short, for each separate entity, any related-entity transactions or shared costs must be recognized or imputed and priced.

#### **Combination (Aggregation)**

Aggregation in a consolidated or combined return will eliminate the effects of intercompany transactions and shared costs between members of a corporate group. These transactions will also be eliminated from the group’s combined receipts factor. To the extent aggregation is not applied, other methods such as transfer pricing, attribution, and add-back rules must be used to ensure net income is fairly calculated.

#### **Attribution**

When income of one entity is attributed to a related entity, the effect is similar to, but not the same as, combination. Attribution is generally limited to the portion of certain income representing the shareholder’s ownership share. For that reason, attribution will effectively eliminate income and expense from intercompany transactions or shared costs only to the extent of the income attributed. For example, if 40% of a subsidiary’s income is attributed to the parent, then 40% of the effects of any intercompany transactions between the parent and subsidiary will be eliminated from net income and from the related apportionment

factor. Therefore, if a CFC has receipts from charges made to the parent, the attributed income of the CFC and the related expense of the parent would be offset and the charges would not be included in the receipts factor. Any residual expense of the parent not related to attributed income may have to be addressed separately.

## **General Background**

In 1983 the U.S. Supreme Court upheld the states' authority to aggregate the unitary business income of multinational groups, including income of foreign affiliates. U.S. foreign trading partners and the federal administration, however, expressed alarm about the use of worldwide combined reporting (WWCR). In response, a Worldwide Unitary Working Group was established by the Treasury Secretary, Donald Regan,<sup>30</sup> composed of members representing federal, state, and business interests, to study the issue. An informal agreement was reached under which states agreed to eliminate mandatory WWCR in exchange for a promise of increased federal enforcement of the transfer pricing rules. The final report of this working group noted two "areas of disagreement" that were not resolved. The first was whether states should be allowed to tax foreign dividends paid to domestic parents. The second was the extent to which states should include entities with foreign activities in the unitary combined filing group. A third topic the members of the Working Group discussed was the treatment of passive subpart F income included in the federal tax base.

In the years that followed, states were involved in extensive litigation over the taxation of foreign dividends and passive subpart F Income. States varied, however, in defining the scope of the water's-edge combined group that was endorsed by the working group. The most important distinction in state systems concerned the inclusion of U.S. corporations with 80% overseas property and payroll, the so-called 80/20 companies.

## **State Taxation of Foreign Dividends**

In general, corporate income is taxed twice. That is, it is taxed to the corporation when earned and also taxed when distributed to shareholders. These shareholders may be individuals or entities taxed as individuals (e.g., certain trusts), passthrough entities, or other corporations. Corporate shareholders may receive dividends from closely held subsidiaries engaged in business activities related to the shareholder's own activities, but they may also receive dividends from minority stock interests held for investment or other reasons.

Under the federal tax system, dividends paid between members of the consolidated filing group are eliminated under the consolidated filing rules. The federal system also provided dividend received deductions (DRDs) for most domestic dividends, but not foreign dividends. See IRC Secs. 243 and 245. As discussed in Section II, under TCJA, foreign dividends are now also subject to a DRD.

### **Early Litigation**

Litigation over state taxation of foreign dividends began in the 1970's with taxpayers arguing such dividends were non-unitary, that is, unrelated to their U.S. business activity, and further, that inclusion in the apportioned tax base constituted taxation of extra-territorial

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<sup>30</sup> See supra footnote 3.

activity. Foreign dividend taxation was the subject of two important U.S. Supreme Court decisions from 1980 through 1992, with the Court recognizing that foreign dividends could be subject to state tax when part of the domestic parent’s unitary business.<sup>31</sup>

### **The Worldwide Working Group Reached No Agreement**

During the deliberations of the Worldwide Working Group, those representing state interests put forward a number of arguments for taxing foreign dividends. One was the fact that, as the U.S. Supreme Court had recognized, U.S. parents of foreign subsidiaries may contribute to the income of those foreign subsidiaries in ways that simply cannot be captured by separate entity accounting. Another argument was based on the evidence showing that dividends might simply be surrogates for other types of income which would be taxable, such as interest, royalties, management fees, or transfers to cover shared costs.

Those representing business interests argued that state taxation of foreign dividends was inconsistent with the “source-based” system adopted by states that generally uses formula apportionment to determine the source of income subject to tax in the year recognized.

Following the states’ agreement to eliminate the requirement for worldwide combined filing, most states continued to include foreign dividends in their tax bases. In response to concerns over extra-territorial taxation, some states adopted policies requiring some amount of factors related to the foreign subsidiaries operations in the parent’s apportionment calculations, or alternatively enacted dividends-received deductions that varied from 50% to 100%.

### **The Kraft Decision**

In the 1992 *Kraft General Foods v. Iowa* case, the U.S. Supreme Court held that Iowa’s conformity to the federal tax code—where foreign dividends were taxed while domestic dividends were not—constituted facial discrimination against foreign commerce.<sup>32</sup> Critically, Kraft had filed on a separate entity basis, which Iowa allowed. The Court stated in a footnote that it would be “hard-pressed” to find discrimination had Iowa used a water’s-edge combined filing system, where all the income of domestic subsidiaries would be included in the tax base to be apportioned, while only the dividends from CFCs would be similarly included.

Subsequent state court decisions upheld the inclusion of foreign dividends in water’s-edge combined filing systems.<sup>33</sup> Nonetheless, many combined filing states opted to eliminate most or all foreign dividends from their tax bases. Separate-entity states likewise eliminated almost all foreign dividends from the tax base.

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<sup>31</sup> See, for example, *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425 (1980); *Asarco Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307 (1982); and *F. W. Woolworth Co. v. Taxation & Revenue Dep’t of N.M.*, 458 U.S. 354 (1982).

<sup>32</sup> *Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Finance*, 505 U.S. 71 (1992).

<sup>33</sup> See *Appeal of Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (1993), and *E.I. Du Pont de Nemours & co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996).

## Passive Subpart F Income

As noted in Section II, the federal tax system has long recognized that, in order to prevent a very pervasive type of income shifting using investments, the passive income of CFCs should be attributed to the domestic parent pro rata based on their ownership share in the year that income is recognized by the CFC. This passive subpart F income consists of the earnings from investments and certain other passive activities reported by CFCs in low tax jurisdictions. The federal tax on this subpart F income is subject to a deemed credit for foreign taxes paid, subject to certain limitations. See IRC Sec. 960.

### **The Worldwide Working Group’s Recommendation on Subpart F**

Whether states should conform to the federal attribution treatment of passive subpart F income was also discussed in the deliberations of the Worldwide Working Group. The group recognized and acknowledged the income-shifting problem that this passive subpart F income created. But rather than simply allowing states to include the income in the parent’s taxable base (with or without a share of the subsidiaries’ representative factors), the agreement ultimately recommended that states adopt certain audit and information reporting requirements.

Under these requirements, states could condition allowing water’s-edge reporting for MNEs that had subpart F income on whether the MNEs agreed to provide certain information on the income and its location. Otherwise, the group might be required to file on a worldwide combined basis. In addition, the agreement reached by the working group would have had the federal government devote substantial additional resources to enforcing transfer-pricing rules that were recognized as affecting subpart F income.

### **The Error in Treating Subpart F Income as “Deemed Dividends”**

It appears that, over time, most states came to equate passive subpart F income, attributed to the parent in the year earned, with foreign dividends actually paid to the parent out of CFC cumulative earnings, despite the substantial differences between these two types of income. Sometimes state rules referred to this passive subpart F income to as “deemed dividends,” a term that the Internal Revenue Code never uses in this context. And this characterization is also at odds with longstanding federal precedent, including the 2024 U.S. Supreme Court decision in *Moore v. United States*, which said this:

*Since 1962, Congress has likewise treated American controlled foreign corporations as pass-throughs. That 1962 law (known as subpart F) attributes certain income, mostly passive income, of American-controlled foreign corporations to their American shareholders and then taxes those shareholders on that income.*

In ruling against the Moores, the Court then went on to say:

*... the Moores try to distinguish Congress’s long history of taxing shareholders of closely held foreign corporations—including through subpart F—on the ground that those laws apply “the doctrine of constructive realization.” ...*

*The Moores have not pointed to any use of the phrase “constructive realization” in this Court’s case law or the Internal Revenue Code.*

In other words, the treatment of subpart F income is the same as for partnership income—it is attributed to the parent or owner for tax purposes. But because many states determined, instead, that subpart F income was a “deemed dividend,” they applied their tax systems’ DRDs to this income.

When it comes to the state tax system, a critical difference between actual dividends and subpart F income is the period to which the income relates. When taxing dividends, it may be difficult for states to provide the right amount of factor representation (by including a share of the CFC factors in the parent’s apportionment formula) because the period to which the dividends relate may encompass multiple prior years. This is not true for subpart F income. To the extent that the state tax system would include apportionment factors related to the CFC’s passive income in the parent’s apportionment formula, those factors can easily be determined based on the current year’s filings.

## **State Water’s-Edge Combined Filing Rules**

The way in which states have come to define the water’s-edge group can affect the extent to which international income shifting can be used to shift income out of the state tax base. Like the treatment of foreign dividends and passive subpart F income, these definitions of the combined filing group evolved over time subject to various factors.

### **Options Proposed by the Worldwide Working Group**

The Worldwide Working Group did not settle on a particular form of water’s-edge filing but the options it considered generally excluded certain foreign entities or entities with substantial foreign operations—measured by their property, payroll, and/or sales in the U.S. One issue the working group considered was whether it would be constitutional for states to include U.S. companies with substantial foreign operations while excluding foreign companies with similar foreign operations. Another issue was whether the determination of the company’s foreign operations should be based on the percentage of domestic property and payroll alone or also on the percentage of domestic sales (receipts).

### **Why State Water’s-Edge Rules Matter when it Comes to Taxing Passive Subpart F or NCTI**

Most so-called 80/20 rules look to the factors of each entity to determine whether it meets the test for sufficient domestic activity to be included in the state water’s-edge combined return. The approaches used vary in terms of the entities that may be included. Excluding U.S. corporations that have less than 20% of their property, payroll, or sales in the U.S. opens the door to allowing these entities to be used to recognize the federal attribution of passive subpart F income or NCTI, thus excluding that income from the state tax base.

## **The MTC's Combined Filing Model Defines the Water's-Edge Group Broadly**

The MTC's combined filing model, adopted for recommendation to the states, includes all or a portion of income and related apportionment factors of an entity that is part of the unitary business if the entity:

1. Is incorporated in the U.S. or any territory or possession;
2. Has an average property, payroll, and sales (receipts) factor of 20% or more (regardless of where incorporated);
3. Is a domestic international sales corporation as described in IRC Secs. 991 to 994;
4. Is a foreign sales corporation described in IRC Secs. 921 to 927 or an export trade corporation described in IRC Secs. 970 to 971;
5. Has income derived from or attributable to sources within the United States, under federal sourcing rules without regard to federal treaties;
6. Is a CFC giving rise to passive subpart F income;
7. Has more than 20% of its income, directly or indirectly, from intangible property or services where that income gives rise to deductions for other members of the group.
8. Operates in a tax haven.<sup>34</sup>

Because this list constitutes the entities that are *included* in the water's edge group, then to the extent an entity meets *any* of these criteria, it would be included. This means that while the rule may exclude certain entities that have less than 20% of their factors in the U.S. (No. 2 above), if the entity is incorporated in the U.S. (No. 1), it would still be included. Also, to the extent the entity has U.S. income under federal rules (No. 5), it would be included. The same is true for CFCs giving rise to passive subpart F income (No. 6) and entities that have more than 20% of their income from related-entity transactions involving sales of intangibles or services (No. 7) or operate in tax havens (No. 8).

### **Market-Based Receipts Factor Sourcing**

To the extent a state's 80/20 rule looks to the amount of receipts in the U.S. as part of the determination of when an entity is included, the method for sourcing those receipts may also matter. When UDITPA was originally drafted by the National Conference of Commissioners on Uniform State Laws, now known as the Uniform Law Commission (ULC), the drafters believed that it would be difficult to determine the market-source for transactions not involving the sale of tangibles. Therefore, for all transactions other than the sale of tangible property, including those involving services and intangibles, it adopted an approach based on the location of the predominant cost incurred in the performance of income producing activities.

The ambiguous language in UDITPA's sourcing rules for receipts from the performance of services and the utilization of intangible property led to decades of litigation over their meaning and inconsistent results that often did not reflect the contribution of the

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<sup>34</sup> See page 10 of the Finnigan combined filing model on the MTC website, here: <https://www.mtc.gov/wp-content/uploads/2025/12/Final-finnigan-Model-1-correction-with-resolution-for-posting.pdf>.

marketplace to income generation. Similarly situated sellers might end up with very different sourcing and apportionment results based on incidental facts and circumstances.

Because of the potential inequity in the treatment of sellers of tangible property versus sellers of services and intangibles, beginning in the early 2000's states began adopting market-based sourcing for receipts from transactions involving services and intangibles. Today, this is the approach used by most states. Note that both the predominant cost of performance method and the market-based sourcing method may lead to different sourcing results than would be found under federal sourcing rules.

## **Summary**

States considering conformity to the federal treatment of NCTI should also consider their current treatment of passive subpart F income, dividends, and their rules for determining the water's-edge group, especially whether CFCs giving rise to attributed income under IRC Sec 951A should be included in the water's edge group.

## IV. State Conformity, Options, and an Alternative

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Every state that conforms to the federal tax system's computation of net income and excludes foreign entities from combined filing requirements must rely on the federal system to prevent income shifting. To the extent this federal system will now rely much more on attribution of CFC income rather than on transfer pricing adjustments to reduce profit shifting, states must consider how this will affect their corporate income tax and whether to conform to these new federal provisions. In doing so, a range of options exists.

But states also have an alternative they may consider. As noted throughout this briefing book, while states informally agreed not to impose worldwide combined reporting (WWCR) in the 1980's, much has changed since then. For its part, the federal government agreed to ensure enforcement of transfer pricing rules so as to control income shifting and protect the domestic tax base. Not only has transfer pricing long proven exceptionally difficult to regulate—as ongoing litigation makes clear—but the shift to using attribution also suggests that states cannot expect the federal government to meet their part of that informal agreement.

In deciding between several approaches, state policy-makers should be aware of some important issues that may arise. One important consideration is their revenue impacts, which is a subject we can only partly address at this point, but which is being studied by various groups.

### Federal Conformity – Policy Choices

The states face different policy choices when considering whether and how to conform to the important changes made to the federal international tax system. States that have not yet conformed to passive subpart F income may want to consider doing so. And states may also consider whether and how to conform to provisions of the recent OB3 legislation.

#### **Passive Subpart F Income**

As noted in Sections II and III, the federal system has long recognized that attributing passive subpart F income from CFCs to the domestic parent is essential to control one of the most pervasive types of income shifting. This attributed income is not equivalent to foreign dividends such that any state dividend treatment need apply. Therefore, states may decide to conform to the federal treatment of this income. But as noted in Section III, to ensure this income is not effectively removed from the state filing group, states should also review their applicable 80/20 or water's-edge filing rules.

One question that generally arises when any income is included in the tax base is the effect on the apportionment factor and whether factor representation is necessary. Given that subpart F income is passive income, if it were domestic income, many states would not include any related factors. For example, the MTC's model General Allocation and Apportionment Regulations exclude any receipts that are related to passive investment

income from the receipts factor.<sup>35</sup> (Factor representation for NCTI income is discussed further below.)

### **International Provisions of OB3**

In determining whether and how to conform to the international provisions of OB3, the primary questions are whether to allow the IRC Sec. 250 special deductions and also whether to provide for factor representation when including NCTI.

#### **IRC Sec. 250 Special Deductions**

As noted in Section II, IRC Sec. 250 provides two special deductions for corporate taxpayers. The first is the 40% deduction from NCTI found in IRC Sec. 250(a)(1)(B). This deduction is not provided to individual shareholders of CFCs. Nor is it the typical kind of deduction used for subtracting expenses when computing net income. Instead, this deduction is simply used to reduce the federal effective corporate tax rate from 21% to 14%, reflecting the evolving international tax policy of imposing a minimum tax on global income.<sup>36</sup>

The purpose of the FDDEI deduction, found in IRC Sec. 250(a)(1)(A), is similar to the 40% deduction except that it is not related to the calculation of NCTI. The FDDEI deduction reduces the effective federal corporate tax rate on certain export (outbound) income from 21% to 14%. And this, in turn, removes any disincentive to locate operations or make foreign sales from the U.S., the income from which would otherwise be taxed more than the minimum rate imposed on NCTI.

States generally do not conform to federal tax rates. Therefore, there is no reason to conform to these special deductions. Some may argue that the FDDEI deduction also represents a kind of incentive for MNEs to locate operations in the U.S. But for states, this is yet another reason not to conform to this special deduction since the dormant foreign commerce doctrine may prohibit states from providing such incentives to the extent they discriminate against foreign commerce.

#### **Factor Representation**

In the past, questions of whether to allow some kind of factor representation for foreign income included in a state's tax base were typically raised in the context of foreign dividends. The difficulty with including some share of the foreign subsidiary's factors, however, is that dividends are paid out of the earnings and profit accumulated over time—sometimes years. So, determining the share of foreign factors to include would mean considering the factors from multiple prior years, which might change dramatically in amount and source.

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<sup>35</sup> See those model regulations here: <https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf>.

<sup>36</sup> Supra footnote 22.

Another solution is to treat foreign dividends like regular out of state income and achieve factor representation by including the dividend in both the parent's income and in the denominator of the parent's sales or receipts factor.

Another option taken by many states is taxing only a portion of those dividends. By taxing only a portion, a state could argue that it was effectively estimating the amount of the dividends that would properly be sourced to the U.S. as part of the domestic tax base subject to apportionment among the states using only the domestic factors. However, that method may understate or overstate the amount of income fairly attributable to the U.S. and the state.

Some states may have also taken a similar approach to taxing GILTI under the TCJA—either including GILTI in both the apportionable income and in the sales or receipts factor or including only a portion of GILTI in apportionable income and using domestic factors to apportion it.

As noted in Section III, NCTI is not dividend income. It is not actually paid out by the CFC to the parent as cash or assets. Rather, it is income earned by the CFC and attributed to the parent in the current tax year. Therefore, the treatment of foreign dividends needs not, and should not, control the treatment of NCTI.

In considering what option to take in conforming to the taxation of NCTI, states should note the following:

- First, under the rules for reporting NCTI, taxpayers must maintain information on their CFC's net income, determined under federal tax rules, as well as on gross income or receipts, and will report that information as part of the parent (or domestic group's) federal returns. As a result, providing for some type of factor representation for NCTI would appear to be more straightforward than for foreign dividends.
- Second, as noted in Section II, GILTI and NCTI are computed differently, particularly with respect to the federal QBAI deduction, which was allowed in computing GILTI in order to estimate the profit earned from foreign intangible versus tangible assets. States might argue, therefore, that GILTI was the deemed domestic profit from intangibles and, as such, could be included in the domestic tax base and apportioned using domestic factors without any foreign factor representation. This theory was not effectively tested in litigation and whether states might have prevailed is uncertain. In any case, this QBAI deduction is no longer a part of the computation of NCTI.
- Third, in general, the state tax system as described in Section I is based on the principle that income, including foreign income, can be fairly sourced using formulary apportionment. States that tax more than a small portion of NCTI may face challenges for not allowing some type of factor representation. Also, this possibility may be greater for NCTI than GILTI because as noted above, NCTI will be a larger amount

since the QBAI deduction is no longer allowed and HTJ exclusions should be triggered less.<sup>37</sup>

- Fourth, if a state includes only a portion of NCTI, any factor representation should be similarly limited. So, a state that includes 50% of NCTI should not include more than 50% of the related factors in the parent's apportionment formula. (And assuming the state chooses to treat NCTI as receipts for purposes of the receipts factor, it should not include more than 50% of the NCTI in the denominator.)
- Finally, it may be somewhat more difficult to estimate the revenue impact of taxing NCTI with factor representation than without. One thing to keep in mind is that NCTI itself will always be a positive number (since net losses are not included in the parent's income). Also, one aspect of formulary apportionment generally is how profit margins of entities can affect the results of combining or attributing their income.

As a simple example, assume two related entities forming a unitary business:

- 1Co. operates entirely outside Taxing Jurisdiction
- 2Co. operates entirely within Taxing Jurisdiction
- 1Co. has \$1,000,000 of receipts with a 10% profit margin = \$100,000 of income
- 2Co. has \$5,000,000 of receipts with a 10% profit margin = \$500,000 of income
- Income reported to Taxing Jurisdiction:
  - Without combination or attribution = \$500,000  
(\$500,000 income x 100% factor)
  - With full attribution of 1Co. income and factors = \$500,000  
(\$100,000 X \$5,000,000/\$6,000,000)

Now, instead, assume two other related entities forming a unitary business:

- High Profit Co. (HP) operates entirely outside Taxing Jurisdiction
- Low Profit Co. (LP) operates entirely inside Taxing Jurisdiction
- HP has \$1,000,000 of receipts with a 50% profit margin = \$500,000 of income
- LP has \$5,000,000 of receipts with a 10% profit margin = \$500,000 of income
- Income reported to Taxing Jurisdiction:
  - Without combination or attribution = \$500,000  
(\$500,000 LP income x 100% factor)
  - With full attribution of HP income and factors = \$833,333  
(\$500,000 X \$5,000,000/\$6,000,000)

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<sup>37</sup> A separate challenge could be based on whether the CFC is unitary with the parent. We would expect that most CFCs would be unitary.

Here, Taxing Jurisdiction receives additional income because HP's receipts give rise to relatively higher income than LP's factors. (If the reverse were true, Taxing Jurisdiction would receive less income.)

But also note – here, there were no intercompany transactions in the current year. Assume HP's receipts were entirely from charges to LP. In that case the effects on the income and factors of LP would be eliminated. (That is, the additional receipts of HP would be offset by the corresponding expense of LP and HP's factors would be excluded from LP's apportionment formula.)

One final consideration for states in taxing NCTI is the option of using worldwide combined filing as a “baseline” for fairness so that a taxpayer claiming that inclusion of NCTI or the lack of factor representation results in distortion might offer to allow the group to pay tax under a worldwide combined return. (See further discussion of worldwide combined reporting below.)

## **Comparing Federal Conformity to Worldwide Combined Reporting**

A minority of states currently provide corporate groups with the alternative to file on a worldwide basis. The MTC model combined filing statutes provide that worldwide combined reporting (WWCR) is the default approach, with an election for water's edge filing.<sup>38</sup> In responding to the changes at the federal level, states may see the use of WWCR as a more straightforward approach to including some or all of federal NCTI. Comparing the treatment of MNEs under both approaches highlights some important differences:

### **Ease of Administration**

One potential difference between conforming to the federal treatment of NCTI versus imposing WWCR is the administrative and enforcement burdens each may pose.

Given that domestic MNEs will be required to report the amount of NCTI on their federal tax return, along with certain information on the gross income giving rise to this NCTI, it may appear that simply including all or a portion of NCTI (with a share of any related apportionment factors) would be less burdensome. However, as noted in this section, one issue states may have to consider is whether the CFCs giving rise to the NCTI are part of the unitary business for the combined group filing in the state, and how to treat MNEs in high-tax jurisdictions that may be excluded.

While WWCR would involve taking a somewhat different approach to the same issue addressed by NCTI, and would involve additional reporting of information not included in the federal return, the WWCR is a tested method already used by several states either as a mandatory or elective method to determine the net income tax base. Also, the information that will now be reported on the federal return for purposes of taxing NCTI may be useful to states in administering a WWCR approach.

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<sup>38</sup> See page 9 of the Finnigan combined filing model on the MTC website, here: <https://www.mtc.gov/wp-content/uploads/2025/12/Final-finnigan-Model-1-correction-with-resolution-for-posting.pdf>.

## **Treatment of Losses**

There is an important exception for the attribution of NCTI to U.S. parents—no amount will be attributed to the extent the NCTI calculation results in a net loss. The reason for excluding net losses is because the purpose of NCTI is simply to impose a minimum tax on the global income of the parent, not to allow CFC losses (which can effectively be created) to reduce domestic income or create a domestic net operating loss.

In contrast, WWCR does not exclude the net losses generated by foreign subsidiaries from the combined income.

## **Treatment of Foreign MNEs**

Changes under the federal system do not affect how foreign-based MNEs are treated. These foreign corporations and groups will continue to be taxed only to the extent they have income effectively connected to a permanent establishment in the U.S. In contrast, WWCR would generally include foreign corporations to the extent that they have sufficient economic presence (sales or receipts) in the state. States that use market-based sourcing would source the receipts of those entities based on the customer or market for any transactions, whether involving tangibles, intangibles, or services.

## **Consistency with the Unitary Business Principle**

The unitary principle will apply in the determination of apportionable income whether states choose to conform to the taxation of NCTI or to impose WWCR. In this respect, it is important to note that the MNE may have more than one unitary business, in which case, the state might apply separate apportionment formulas, and would also presumably source certain “nonbusiness” or non-apportionable income using the typical rules of assignment applied to similar income of a domestic corporation.

As noted above, because NCTI is linked to the definition of CFCs, which requires a level of control that can be as low as 10% for each U.S. shareholder, some CFCs may not be considered part of the unitary business. It is likely, in these cases, that the income of these CFCs would not be sourced to the state.

## **Treatment of Oil and Gas Companies**

A difference that can be quite meaningful for some states is the exclusion of foreign oil and gas extraction income from the attribution of income under IRC Sec. 951A. That exclusion reflects a policy choice at the federal level that may not suit state priorities. States could obviously conform to IRC Sec. 951A and decouple from that specific provision. That means that state returns of oil and gas companies would have to calculate NCTI as a state addition. Mandatory WWCR would by default include foreign oil and gas extraction income in the scope of its income tax base.

## Appendix

This appendix walks through some simple computations of tax to show the basic computation using different approaches and assumptions.

Strict conformity with the federal system results in a combination of income that often excludes many related foreign entities and increases the risk posed by intercompany transactions. Combining more related entities—whether by decoupling from the high tax exclusion, adopting a broad water’s-edge standard, or by adopting WWCR—reduces that risk.

Assume a domestic corporation DC which files a domestic return. DC owns CFC 1 and CFC 2. DC is owned by a foreign corporation, FC. CFC1 and FC are in a high tax jurisdiction while CFC 2 is in a low tax jurisdiction. The state uses a single sales factor with market-based sourcing. Because of the rules used by the state none of the CFCs or FC are included in the tax base.

	DC	CFC 1	CFC 2	FC
Net Income	\$1,000,000	\$500,000	\$700,000	\$4,000,000
Receipts	\$12,000,000	\$5,000,000	\$700,000	\$10,000,000
ROI	8.3%	10%	100%	40%
State Receipts	\$500,000	\$0	\$0	\$0
Factor	4.1%	0%	0%	0%
Source Income	\$41,000	\$0	\$0	\$0

With strict conformity, if DC elects for the high tax exclusion for CFC 1, its return will consist of DC income combined with CFC 2 income. Any intercompany transactions between CFC 2 and CFC 1 or FC are not eliminated.

	DC	CFC 2	CFC 1	FC
Net Income	\$1,700,000		\$500,000	\$4,000,000
Receipts	\$12,700,000		\$5,000,000	\$10,000,000
State Receipts	\$500,000		\$0	\$0
Factor	4%		N/A	N/A
Source Income	\$68,000			

With decoupling from the HTE, the return includes DC, CFC 1 and CFC 2, but not FC. The inter-company transactions, \$700,000, between CFC 1 and CFC 2 are eliminated from the factor.

	DC	CFC 2	CFC 1	FC
Net Income	\$2,200,000			\$4,000,000
Receipts	\$17,000,000			\$10,000,000
State Receipts	\$500,000			\$0
Factor	3%			N/A
Source Income	\$66,000			

With WWCR, all income is combined and all intercompany transactions inside the unitary group are eliminated and DC paid \$3,000,000 of royalties to FC.

	DC	CFC 2	CFC 1	FC
Net Income	\$6,200,000			
Receipts	\$24,000,000			
State Receipts	\$500,000			
Factor	2.1%			
Source Income	\$130,200			