Senate Committee on Revenue and Taxation
Assembly Committee on Revenue and Taxation

Joint Informational Hearing

“Peering Over the Water’s Edge: State Taxation of Foreign Subsidiary Income

WITNESS MATERIALS

February 11, 2026, 9:30 a.m.
State Capitol, Room 112

State of California

Franchise Tax Board

Memorandum

To : Steve Larson, Senate Budget & Fiscal Review
Dave Doerr, Assembly Revenue and Taxation
Martin Helmke, Senate Revenue and Taxation
Judi Smith, Assembly Ways and Means
Traci Bartholomew, Senate Minority Leader's Office

Date : May 6, 1987

File No.:

Telephone 916/369-4543
ATSS 8/468-4543

From : Gerald H. Goldberg

Subject : Treasury News Release - British Government

I thought you would appreciate knowing that the British government has confirmed it will not take retaliatory action against corporations headquartered in unitary states before December 31, 1988, unless the British government gives notice otherwise. In all likelihood, as a result of SB 85, the threat of retaliation has disappeared, even though the British would still like to see the election fee eliminated and a 10-year contractual commitment reduced in length.

Jerry

Executive Officer

Doc 87-2381

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 13, 1987

CONTACT: Charles Powers
(202) 566-8773

The Treasury Department announced today that the British Government has confirmed that it will not take action under Section 54 of the U.K. Finance Act 1985 to deny refund of the Advanced Corporation Tax on dividends paid by British corporations to United States corporate shareholders before December 31, 1988, unless the British Government gives notice otherwise. Section 54 authorizes the British Government to deny certain U.S.-U.K. tax treaty benefits to corporations that conduct significant business in states of the United States that impose taxes on a unitary basis. If the British Government does give notice that it will take action under Section 54 with respect to dividends paid before December 31, 1988, such action will not be applied to dividends paid before the date of the announcement.

A copy of a press release issued by the British Government is attached.

o O o

B-948

87-2381 H. M. TREASURY

Parliament Street, London SW1P 3AG. Press Office: 01-270 5238
Facsimile: 270 5244
Telex: 9413704

25 March 1987

UNITARY TAX

The Financial Secretary to the Treasury, the Rt Hon Norman Lamont MP reaffirmed today that the Government will not recommend the repeal of the powers to withdraw UK tax credits from US parent companies situated in states which impose worldwide unitary taxation.

He said, however, that the powers would not be applied retrospectively if activated before the end of 1988: if activated thereafter they would not apply to dividends paid on or before 31 December 1988.

In reply to a Parliamentary Question the Financial Secretary said:

> "The Government announced on 18 December 1986 that, while it does not intend to recommend the repeal of Section 54 of the Finance Act 1985, it is prepared to defer initiating action under Section 54 for the present in recognition of the progress that has been made towards resolving the unitary tax issue. In the meantime progress towards a final resolution of the unitary tax issues will be kept under careful review. Should it be necessary to take action under Section 54 before 31 December 1988 it will not apply to dividends paid before the date of the announcement of such action. If it is necessary to take action thereafter, it will not apply to dividends paid on or before 31 December 1988".

PRESS OFFICE
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01-270 5238

20/87

STATE OF CALIFORNIA
Franchise Tax Board

How Foreign Subsidiaries are Taxed in California

Jennifer Barton – Director, Legislative Services Bureau
John McMahan – Chief Economist, Economic & Statistical Research Bureau
February 11, 2026

Background

When a corporation derives income from sources both in and outside of California, a portion of the that income may be taxed by California.

If a corporation consists of multiple entities that engage in a unitary business, it completes a "combined report" to compute its California tax liability.

LLCs and partnerships are included while S corps are not included.

A combined report is not the same as a federal consolidated report, and it is not a tax return or tax form.

The Combined Report

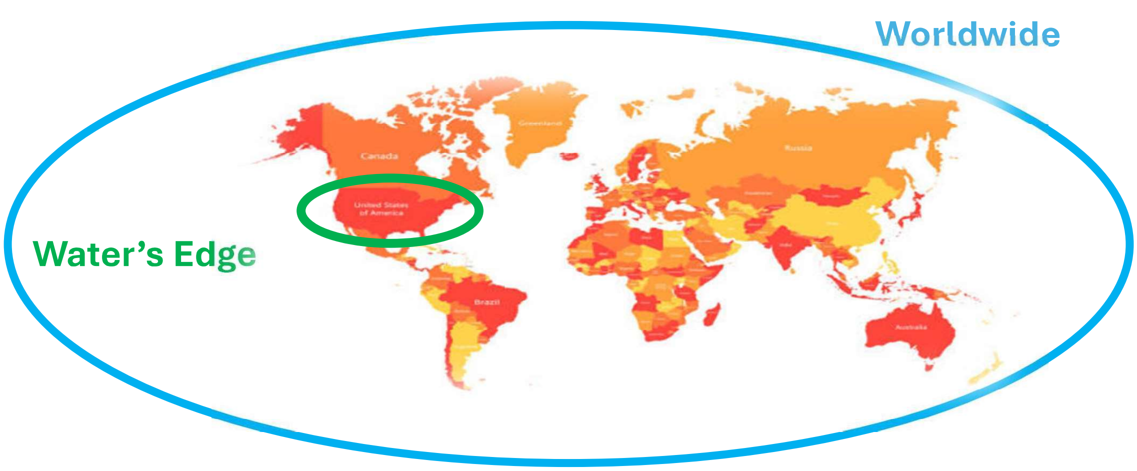
Worldwide Unitary Group Business Income

Water's Edge Unitary Group Business Income

California Apportioned Group Business Income

Individual Entity California Business Income

Two Methods for Reporting Corporate Income



Water’s Edge Election

A Water’s Edge election is valid if:

1. The Corporation’s tax is computed in a manner consistent with the Water’s Edge method; and

2. A written notification of election is filed with the return or on a form prescribed by the Franchise Tax Board.

Election must be made by every member of the combined report that is subject to tax.

Water’s Edge Election

Election is valid for 7 years (84-month) period.

How to terminate Election:

- After 84-month period, a corporation terminates by using the Worldwide filing method;
- During the 84-month period, a corporation may terminate with the consent of the Franchise Tax Board

Water's Edge versus Worldwide

In theory, the Worldwide and Water's Edge methods should have similar results because the amount of sales made to California is the same regardless of which method is used.

However, in reality, when the income of foreign entities are eliminated from the combined report due to the water's edge election, the total amount of income subject to tax decreases, which in turn results in less tax being assessed.

Water's Edge versus Worldwide

Fact pattern: Foreign entities generate greater sales and income than domestic entities

	DOMESTIC Entity A	DOMESTIC Entity B	**Sum Domestic**	FOREIGN Entity C	FOREIGN Entity D	**Sum Foreign**	**Sum All Entities**
Separate Company Net Income	40,000,000	10,000,000	**50,000,000**	175,000,000	25,000,000	**200,000,000**	**250,000,000**
California Sales	25,000,000	-	**25,000,000**	-	-	**-**	**25,000,000**
Everywhere Sales	150,000,000	50,000,000	**200,000,000**	525,000,000	100,000,000	**625,000,000**	**825,000,000**

Water's Edge versus Worldwide

	WATER'S EDGE	WORLDWIDE
Total Group Income	$50 million	$250 million
Total California Sales	$25 million	$25 million
Total Everywhere Sales	$200 million	$825 million
Appt Percentage	12.5%	3%
Income appt to California	$6,250,000	$7,575,758
California Tax on Appt Income	$552,500	$669,697

Tax savings by making water's edge election $117,197

Water's Edge Statistics

Table 1: Form Filing Counts and Share of Tax Liability

	Form 100W	Form 100
Count	21,562	337,278
Count %	6.0%	94.0%
Total Tax Liability	49%	51%

Water's Edge Statistics

Table 2: Industries electing Water's Edge method

	Count	Share of liability
DURABLE/NONDURABLE GOODS AND WHOLESALE	33%	29%
PROFESSIONAL, SCIENTIFIC, AND TECHNICAL SERVICES	23%	4%
HOLDING COMPANIES	10%	20%
FINANCE, INVESTMENT, AND INSURANCE	6%	23%
REAL ESTATE	6%	3%
ALL OTHER INDUSTRIES	23%	21%
Total	100%	100%

Water's Edge Statistics

Table 3: Percentage of taxpayers switching method of filing

	2017	2018	2019	2020	2021	2022	2023
Form 100W	6.6%	6.0%	6.1%	2.2%	5.6%	5.0%	4.6%
Form 100	-0.2%	-0.7%	1.0%	0.1%	1.1%	0.2%	0.6%

Assembly & Senate Committees on Revenue & Taxation
Joint Informational Hearing

Peering over the Water's Edge: State Taxation of Foreign Subsidiary Income

February 11, 2026

Testimony of Darien Shanske

Executive Summary[1]

As an academic, I see my role as providing the Legislature with supplemental context in considering how it might reform corporate income taxation in the state. My goal is to acknowledge a wide variety of perspectives and sources in order to enable the best possible decisions for the people of the state.

To start, all public finance and tax policy is comparative. Consider the current situation. OBBBA will impose substantial costs on certain Californians in relation to their medical care. With no state response, then this amounts to a direct tax on those citizens (e.g., loss of health insurance) and an indirect tax on everyone else (e.g., more crowded emergency rooms for everyone). The cost of these implicit taxes must be compared to any explicit tax policy changes.

As to the choice among tax instruments, the analysis is similar. Reforming the CIT is good tax policy on its own but it should be compared to other options. For example, expanding the sales tax could also raise substantial revenue but likely in a more regressive manner.

The water's edge (WE) election is part of California's corporate income tax. It is the largest corporate tax expenditure and among the largest in California's tax system in general. The Department of Finance estimates that it costs California over $4bn/year.[2] The election dates to 1987 and is part of how California addresses nominal versus actual foreign source income.

Eliminating this election would – likely - raise money primarily from the largest, most profitable – and generally most tax aggressive – multinational corporations. Because this change would raise revenue that should already be collected from taxpayers who can afford to pay, this would make California's tax system more efficient and more fair. The primary objection to this reform is administrative, and so one important area I will address is compliance.

Tax Policy Background

The Corporate Income Tax. The corporate income tax is a tax on the profits of corporations. There is a long-running dispute as to who really pays the corporate income tax (e.g., shareholders or workers) and whether the tax overall is a drag on economic activity. The most recent research tends to the conclusion that the tax is borne mostly by shareholders and highly paid workers, which makes the tax relatively progressive.[3] There is also significant recent research that indicates that the tax is relatively efficient. This is because an increasing share of the profits subject to the tax were generated by firms earning supranormal profits. A tax on such profits is efficient because such firms will not reduce their economic activity when that activity is so profitable.[4]

Income Shifting. Income shifting refers to tax planning techniques that move income from the jurisdiction in which it is earned into a lower tax jurisdiction. Here is an example of what this looks like. A big widget company sells 1 million widgets in California. The company's profit margin is $100 per widget and so it should pay tax in California on $100mn in profits. However, the company incorporates a subsidiary in a low-tax jurisdiction, say Ireland, and places its valuable intellectual property in that jurisdiction. The foreign subsidiary charges the US-based company a high licensing rate for use of its intellectual property, say $90 per widget. Because of this new expense, which amounts to one hand paying the other, the US-based Widget corporation reports $10 million in profits in the United States.

The size of the income shifting problem is in dispute, but the weight of authority is that it is a large problem, one that has not been much impacted by national and international efforts to combat the issue. "In 2018-2020, US multinational corporations booked a similar share of their foreign profits in tax havens — around half — as in the years immediately preceding the reform."[5] Indeed, there is convincing evidence that the problem has escalated dramatically since the 1970s, when less than 2 percent of multinational profits found their way to low-tax jurisdictions.[6] This trajectory suggests that income shifting has grown as a problem and could expand further if not combatted. A 2021 Treasury report concluded with notable directness: "Tax havens are as available today as they were prior to the 2017 tax reform."[7]

One prominent estimate is that $300 billion in profits is currently shifted out of the US tax base annually.[8] That is about 20% of the corporate tax base. Note that, given the size of the California tax base, a 20% increase is in line with DOF estimates.

Note that even leading commentators who tend to believe that the income shifting is of absolute smaller size also acknowledge that it is neither fair nor efficient for certain firm to gain an advantage through aggressive tax maneuvers.[9]

Combined Reporting. Notice that in the example, the taxpayer reduced its taxes by essentially paying itself. If the profits of the subsidiary in Ireland were combined with the profits of the US parent, then no income would be lost. Such an approach is called combined reporting. California was a pioneer in the use of this method[10] and it is the reason why a corporation would not avoid California corporate income tax through shifting income to a subsidiary in Nevada or Texas, states without corporate income taxes.

Worldwide Combined Reporting. The logic of combined reporting requires that a whole business be combined wherever it is located. If not extended to foreign subsidiaries, the income shifting will just occur outside of the US, which is, in fact, what happens. California did require combined reporting on a worldwide basis until 1987. The constitutionality of this approach was upheld by the Supreme Court twice.[11] Note that a significant justification for these holdings was due respect for federalism concerns, a type of concern the current Court is likely to be attuned to.

Water's Edge Election. A water's edge election permits a taxpayer not to combine its US and foreign operations and is thus an invitation for income shifting abroad. Also, as an election it loses money for the state in two ways. First, the corporations that shift income out of the US opt for a water's edge election. Second, the corporations with losses abroad opt to be combined and so pay less in California taxes.[12] California did not permit this election on the basis of a policy analysis. Rather, our trading partners, particularly the UK, pressured the federal government and the federal government in turn threatened to preempt the states. Thus, the water's edge election is a compromise result of bullying from the Reagan Administration.

Other Related Component of California's Treatment of "Foreign Income." California's WE election already addresses "foreign" source income, but these provisions are dated and ad hoc.

An apportioned piece of foreign subsidiary income, measured by the proportion of the CFC's Subpart F income, was and is brought back into the California tax base despite the election.[13] Subpart F income is a type of income identified as likely to shifted in the 1960s – exactly how much to bring in despite the WE election was a matter of negotiation in the 1980s.

As for foreign dividends from subsidiaries, the state now taxes 25% of such dividends. This was also a result of negotiation.[14]

National and International Developments. Because there is a broad consensus that income shifting is a problem, there have been numerous national and international developments. In particular, the federal government has passed two sets of provisions meant to combat income stripping. The first, put in place by the Trump Administration, was called Global Intangible Low-Taxed Income ("GILTI") and now called Net Controlled Foreign Corporation (CFC) Tested Income ("NCTI").[15]
The Biden Administration passed the Corporate Alternative Minimum Tax in 2022, which utilizes financial statement income for higher income taxpayers. The international community has proposed – and broadly agreed to – two Pillars of reforms to deal with income stripping (and other issues), Pillar 1 and Pillar 2. Many

countries have moved far along with adopting Pillar 2 in particular. These changes are significant beyond the fact that they show that California would not be out of step in attending to income stripping. Many of the national and international reforms work much like worldwide combined reporting and, in fact, many of them should make worldwide reporting easier.

Compliance Costs. Every tax imposes compliance costs. The right question is whether the burdens are excessive relative to the policy benefits. In this case, common sense and significant evidence suggests the burden will not be too great. Based on evidence collected in the 1980s, courts did not find the burden very large.[16] The notion that current taxpayers, particularly those subject to the CAMT, Pillar 2 and reporting under the securities laws, and only reporting on sales, could not comply at a reasonable cost does not make a lot of sense. Note that California already permits reasonable approximations[17] and has been evaluating WWCR returns for decades.

Water's Edge Election and Competitiveness. There is a claim that worldwide reporting would hurt a state's competitiveness. But this is a bluff. California's corporate tax is not based on the residence of corporations; it is based on where a corporation sells its products. A corporation would not reduce its corporate taxes by moving its facilities out of California; it could only do that by choosing to make fewer profitable sales in California, which does not make a lot of sense. Why wouldn't a sophisticated and profitable corporation not already be charging all it could?

In the end, an argument like this needs to be considered in light of the "compared to what"? question with which I began. Large budget cuts are very likely to be regressive. Other reforms, like reforming the sales tax, would likely be less regressive than the OBBA cuts, but more regressive than CIT reform.

Indeed, there are strong arguments that repealing the water's edge election would make the state *more* competitive for at least two reasons. First, it would eliminate a tax break that gives large, aggressive firms an unfair advantage. Second, the state does give large tax breaks to firms to encourage them to locate in California, particularly the R&D credit. Yet these credits are *against* tax owed, and so they are only valuable if the taxpayer has to pay taxes. Thus restoring the integrity of the corporate tax as to large profitable multinationals could make California's location incentives more effective. Tax credits only work if there is meaningful tax burden to reduce.

Menu of Some Options[18]

- Worldwide combined reporting (WWCR): don't treat income shifted abroad as outside the tax base.
    - Takes advantage of CAMT and Pillar 2.

- Conform to NCTI, which brings back in shifted income by formula.
- Adopt WWCR for large taxpayers, NCTI for smaller.
- In all events adopt other anti-abuse protections.
    - In particular, the state should reform its apportionment rules and cap its R & D credit.

Yes, the state can end the WE. As the Supreme Court has explained, "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."[19] The California legislature can change the prospective terms of an election or eliminate the election. That is not to say that a reasonable transition period might not be appropriate.

I am happy to address any follow-up questions or concerns.

Thank you for the opportunity to engage on this issue.

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[1] For a slightly longer version of the main discussion re WWCR, see Darien Shanske, *White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting*, 89 State Tax Notes 1181 (2018). See also Law Professors Letter on Worldwide Combined Reporting in Minnesota, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4446650.
[2] CA DOF, https://dof.ca.gov/media/docs/forecasting/revenue-and-taxation/tax-expenditure-reports/2025-26-Tax-Expenditure-Report.pdf. ITEP reports a similar number: https://itep.org/worldwide-combined-reporting-state-corporate-taxes/.
[3] William G. Gale and Samuel Thorpe, *Rethinking the Corporate Income Tax: The Role of Rent Sharing*, Tax Policy Center (2022).
[4] Bankman, Joseph and Kane, Mitchell and Sykes, Alan, *Collecting the Rent: The Global Battle to Capture MNE Profits*, Tax Law Review.
[5] See Garcia-Bernardo et al., infra, at 18.
[6] Ludvig S. Wier and Gabriel Zucman, "Global Profit Shifting, 1975-2019," Working Paper 30672 (Nov. 2022).
[7] U.S. Department of the Treasury, "The Made in America Tax Plan" at 9 (Apr. 2021).
[8] Wendy Edelberg et al., *Six Economic Facts on International Corporate Taxation*, Hamilton Project/The Tax Law Center, at 4 (Fact #2: "US multinationals still shift profits into lower-tax countries."). See also: International Monetary Fund, International Corporate Tax Reform, Policy Paper No. 2023/001, at 13 (Feb. 2023) ("According to staff simulations, 18.5 percent of global profit of MNEs is taxed below 15 percent ($1.47 trillion in 2019)"); Javier Garcia-Bernardo, Petr Janský, and Gabriel Zucman, "Did the Tax Cuts and Jobs Act Reduce Profit Shifting by US Multinational Companies?" (May 20, 2022).

[9] See Scott Dyreng, "Are Big Companies Really Moving $100 Billion to Tax Havens?" Duke University, Mar. 19, 2025.
[10] https://www.cbpp.org/research/state-budget-and-tax/states-can-fight-corporate-tax-avoidance-by-requiring-worldwide-0
[11] Barclay's Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994); Container Corp. v. FTB, 463 U.S. 159 (1983).
[12] Accordingly, sophisticated tax advisers advise sophisticated taxpayers to analyze whether WWCR would save them money: See Daniel Sieburg et al., "Worldwide Combined Reporting: An Underutilized Opportunity," The Tax Adviser (Sept. 1, 2019).
[13] Now, formally, what is brought back in is the income of a CFC in proportion to its Subpart F income, but in the usual case Subpart F income is less than the total income of the CFC and so the more Subpart F income of the CFC, the more income of the CFC is included. RTC 25110(a)(2)(A)(ii).
[14] As the legislative history of SB 85 (the statute that first gave us the water's edge election and RTC 24411) indicates, California opted to put in place a watered down version of Option 2. FTB, Bill Analysis SB 85, Jan. 24, 1985 at 5. Option 2 would have included all foreign dividends in the state tax base (subject to apportionment). Option 2 was a particularly protective option advanced by the states. Worldwide Unitary Taxation Working Group (pp. 39-40).
[15] I discuss some issues relating to NCTI here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5703963
[16] "The California Court of Appeal additionally found that Barclays' actual compliance costs were 'relatively modest' during the years just prior to those here at issue, ranging from $900 to $1,250 per annum, for BBI."
Barclays, 512 U.S. 298, 314, n.13 (citing 10 Cal. App. 4th, at 1760, n.9)."
[17] See Cal. Code Regs. tit. 18, section 25106.5-10(e)(1).
[18] I have posted some models here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5167213 (WWCR); https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5201312 (NCTI and SSF and R&D).
[19] United States v. Carlton, 512 U.S. 26 (1994). See also further analysis here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3802629.

Some More Context for Considering the Water's Edge

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Basics of Tax Policy

The goals of tax policy are often summarized as:

- 1) **Fairness**:
  - Similarly situated taxpayers should pay the same.
  - Those with more ability to pay should pay more.
- 2) **Efficiency**
- 3) **Administrability**
- 4) **Sufficiency**: A tax system that taxed all billionaires $1 would satisfy the first three criteria… but the government could not do its job.

Spot the gaps

FIGURE 1

Fifteen Most Likely Tax Havens in 2020 for U.S. Corporations

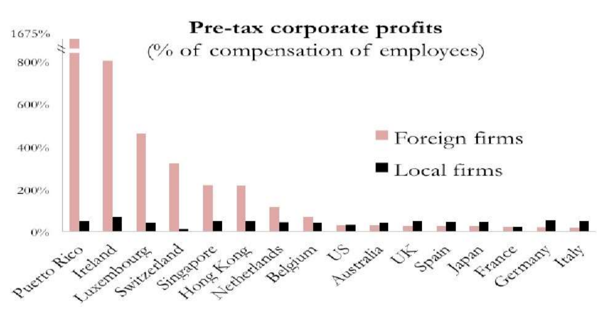
Country	Reported Profits of US Companies (billions)	National GDP (billions)	Profits as % of GDP	Foreign Tax Rate	Profits Per Employee
Bermuda	$39.82	$6.89	578.1%	1.5%	$49,157,126
Cayman Islands	$31.71	$5.65	561.5%	1.7%	$6,874,830
British Virgin Islands	$7.57	$1.49	507.2%	0.7%	$69,428,156
Barbados	$7.59	$4.67	162.4%	1.4%	$4,959,938
The Bahamas	$5.89	$9.75	60.4%	0.0%	$2,921,314
Mauritius	$6.48	$11.40	56.8%	4.2%	$2,195,296
Puerto Rico	$34.29	$103.13	33.3%	1.3%	$418,478
Switzerland	$131.40	$739.91	17.8%	3.9%	$1,428,961
Singapore	$58.41	$348.39	16.8%	5.4%	$339,943
Curacao	$0.27	$2.50	10.9%	0.8%	$1,539,755
Ireland	$45.60	$425.85	10.7%	23.9%	$264,240
Hong Kong SAR, China	$19.21	$344.94	5.6%	13.0%	$214,853
Cyprus	$1.16	$25.01	4.7%	3.7%	$446,806
St. Kitts and Nevis	$0.04	$0.88	4.3%	6.2%	$61,808
Isle of Man	$0.26	$6.68	3.9%	2.4%	$464,566
Total for Most Likely Tax Havens	**$390**	**$2,037**	**19%**	**6%**	**$624,814**
Total for Other Countries	**$270**	**$58,533**	**0%**	**33%**	**$20,413**

Note: Jurisdictions where U.S. corporations reported an overall net loss are not included. These calculations also exclude any jurisdiction that the IRS did not report separately.

Source: Profit and tax data from IRS SOI Country by Country Report for 2020; 2020 GDP

https://itep.org/offshore-tax-havens-corporate-tax-avoidance-demonstrates-need-for-global-minimum-tax/

How about?



Source: http://gabriel-zucman.eu/missingprofits/

But how does profit get to where it was clearly not earned?

For example, imagine Widget, Inc. sells 1 million widgets in CA with a profit margin of $100 each. Instead of paying CA taxes on $100 million in profits, the corporation instead incorporates a subsidiary in a lower-tax jurisdiction and places their intellectual property in that jurisdiction. The foreign subsidiary then charges the US-based company $90 per widget for use of its IP. The US-based Widget corporation now records just $10 million of profits in CA.

And yes, there is granular evidence of such maneuvers, see:

> As Senator Wyden and his team have highlighted, AbbVie systematically transfers nearly all the profits on its patent protected medicines out of the United States. In fact, AbbVie reported a $4.6 billion loss in the United States in 2022 – and a near $20 billion offshore profit. The reported U.S. loss is not an aberration – AbbVie has reported a U.S. loss every year between 2013 and 2022. These domestic losses occur even though AbbVie reports that it generates 75 percent of its revenue in the United States, and its blockbuster drug Humira sells at a substantially higher price in the United States than in Europe.[9]

Source: https://www.finance.senate.gov/imo/media/doc/Setser%20Senate%20Finance%20Testimony.pdf

How much is there?

"[P]rofit shifting is still significant, with companies estimated to be shifting more than $300 billion each year in profits out of the United States, and the share of foreign earnings reported in tax havens little changed."

- Edelberg et al. 2022. Six Economic Facts on International Corporate Taxation. Hamilton Project/The Tax Law Center. (Fact #2: "US multinationals still shift profits into lower-tax countries.").

- This is roughly 20% of the federal corporate tax base.
- A 20% increase in California's corporate income tax would therefore yield $4bn because Ca's CIT collections are about $20bn/yr.
  - *The DoF estimates that eliminating the Water's Edge election would raise about $4bn/yr, which thus seems quite reasonable to me, subject to significant caveats.* [*https://dof.ca.gov/media/docs/forecasting/revenue-and-taxation/tax-expenditure-reports/2025-26-Tax-Expenditure-Report.pdf*](https://dof.ca.gov/media/docs/forecasting/revenue-and-taxation/tax-expenditure-reports/2025-26-Tax-Expenditure-Report.pdf)

Simply Put

- “While the magnitude of corporate profit shifting by U.S. multinationals into low or no tax countries is uncertain, there is overwhelming evidence of its existence and its increase in recent years.”
  - Jane G. Gravelle, Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?, April 2016, http://www.law.nyu.edu/sites/default/files/upload_documents/Jane%20Gravelle.pdf

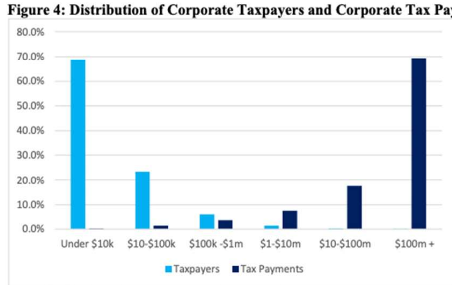
Not getting better

- “Tax havens are as available today as they were prior to the 2017 tax reform.”
  - U.S. Department of the Treasury, “The Made in America Tax Plan” at 9 (Apr. 2021).

There are differences in corporations, with only a handful paying most of the tax.

- Source: Clausing, Kimberly A., Capital Taxation and Market Power (May 21, 2024). Available at SSRN: https://ssrn.com/abstract =4419599

Figure 4: Distribution of Corporate Taxpayers and Corporate Tax Payments, 2019



Source: IRS Statistics on Income data for 2019 on C corporations; see Table 4.

And not all MNCs have equal appetite and/or means

- For example,
- “Our elasticity estimates show that the most tax-aggressive MNEs respond up to 18 times more than do the least aggressive firms.”

- Bilicka et al., *Tax Policy, Investment and Profit-Shifting*, https://www.law.columbia.edu/sites/default/files/2023-03/BDG_2023_03_23.pdf

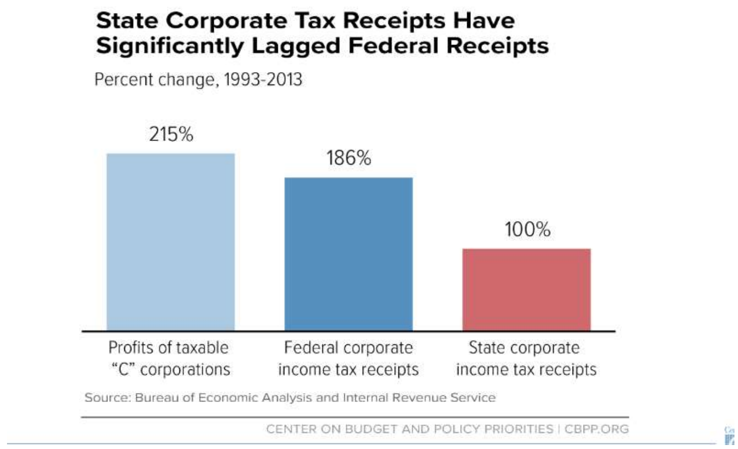
Note on who pays the CIT (Economic incidence)

- Figuring out the economic incidence of the CIT is fraught.
- The general estimate of the Joint Committee on Taxation is that capital bears most of the tax, especially at first, but then:
  - "In estimating the long-run burden of corporate income taxes on capital and labor, the Joint Committee staff follows the middle range of the current economic literature by assuming that 25 percent of corporate income taxes are borne by domestic labor and 75 percent are borne by owners of domestic capital."
- The JCT estimate might be too low, as the nature of corporate profits change. Here is the Tax Policy Center:
  - "A significant portion of the corporate tax (TPC estimates about 60 percent), however, falls on excess returns or economic rents. TPC assumes 100 percent of the tax on economic rents falls on corporate shareholders, although some recent research suggests some of tax on rent may be borne by other corporate stakeholders, primarily top management." https://www.taxpolicycenter.org/briefing-book/who-bears-burden-corporate-income-tax

Thus the design of the Ca CIT fails…

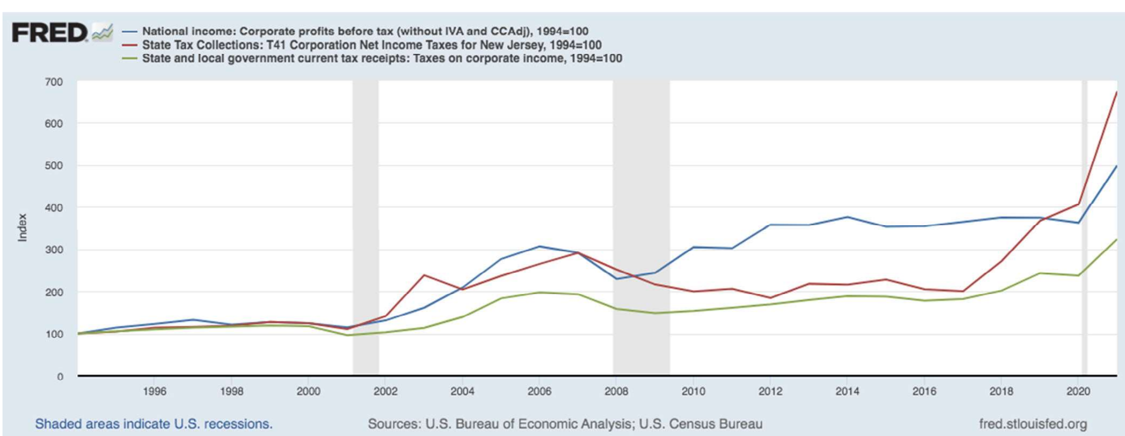
- Every criteria for sound tax policy:
  - It is unfair: to smaller and domestic businesses, but also less aggressive MNCs.
  - It is inefficient, as it encourages wasteful tax evasion.
  - It is hard to administer because of games.
  - The evasion is a big part of the tax base.
    - If you look at California's tax expenditures, none is as large as the Water's Edge election relative to the tax.

Should we just give up?



http://www.ncsl.org/Portals/1/Documents/Taskforces/GILTI.pdf

But NJ !



Caution: NJ adopted several CIT reforms at once (at least one of which CA has already done). The significance of this chart is not to guarantee future results but to show that CIT reform can really matter.

There are several ways forward.

- It is important to reject defeatism. There are multiple solutions available to the state, including:
  - Worldwide combined reporting (WWCR): don't treat income shifted abroad as outside the tax base.
    - Takes advantage of CAMT and Pillar 2.
  - Conform to NCTI, which brings back in shifted income by formula.
  - Adopt WWCR for large taxpayers, NCTI for smaller.
  - In all events adopt other anti-abuse protections.

Alphabet Soup Speed Round

- Ca pioneered WWCR until it was forced to abandon it in 1987.
- The resulting/current compromise means that Ca taxes some ”foreign” source income but ineffectually and irrationally.
  - California currently bring certain income of foreign subs into the tax base of US taxpayers if 1) it represents an older attempt to combat income stripping (subpart F) or a foreign sub actually mails a check back to its US parent (foreign dividends).

NCTI?

- NCTI income is the income of the foreign subs of US multinationals – 60% of that income is brought back into the US taxbase, subject to complicated (and, flawed in their own right) rules as to whether sufficient tax was paid on this income abroad.
- NCTI was created by the TCJA in 2017 and modified by the OBBBA in 2025. Clever tax planners can transform subpart F income (included in Ca) into NCTI income (not included).

Corporate Alternative Minimum Tax

- New tax put in place by Inflation Reduction Act.
- Only applies to big corporations (over $1bn).
- Applies a 15% tax to adjusted financial statement income (AFSI).
- Consolidation – worldwide.
- Use financial statement income v. taxable income.
- Complicated interaction with OBBBA but even if practically eviscerated (for now) still requires large taxpayers to make calculations based on their financial statements.

Pillar Two?

- Pillar Two, a reform developed at the OECD, aims to make sure that every taxpayer pays at least a minimum amount of tax (15%).
- It applies to large taxpayers and requires substantial use of financial reporting data.

But no one else is doing it!?

“A simple analogy from sports refutes the […] point. Suppose that each team in a basketball league inexplicably tied their players’ shoelaces together. A team could clearly improve its competitiveness by untying its players shoelaces, no matter what other teams did.”

- Charles McLure, preeminent tax economist, discussing a similar argument made as to why states should not improve their sales taxes, https://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/hearings/ProfMcLure_Testimony_revised.pdf

Here is some evidence and facts re compliance

- "The California Court of Appeal additionally found that Barclays' actual compliance costs were 'relatively modest' during the years just prior to those here at issue, ranging from $900 to $1,250 per annum, for BBI."
- Barclays, 512 U.S. 298, 314, n.13 (citing 10 Cal. App. 4th, at 1760, n.9)."

Also

- As the Supreme Court also noted in Barclays, under the California WWCR regulations, taxpayers could use "reasonable approximations" based on ordinary financial records for calculating the income of foreign subsidiaries in connection with WWCR.
- These regulations are still there – and still used! – because taxpayers can and do elect to file on a worldwide basis in California. See Cal. Code Regs. tit. 18, section 25106.5-10(e)(1).

More fundamentally

- It is surreal to suggest that these MNCs will have huge difficulties figuring out estimated income and sales.
  - In many cases, they already need to disclose their sales for purposes of securities law or Pillar 2.
  - In many cases, they already have to calculate their income using financial statements for purposes of the CAMT or Pillar 2.
  - BUT given the fact that there is *some* fixed compliance cost – it would not be unreasonable to limit WWCR to taxpayers already subject to the CAMT or Pillar 2.

Federal securities law?

From Amazon's 2022 Annual Report.

	2020	2021	2022
United States	$ 263,520	$ 314,006	$ 356,113
Germany	29,565	37,326	33,598
United Kingdom	26,483	31,914	30,074
Japan	20,461	23,071	24,396
Rest of world	46,035	63,505	69,802
Consolidated	$ 386,064	$ 469,822	$ 513,983

It just makes sense for Amazon to tell us this, but note that it has to under accounting standards. FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 131, 42 (1997). And these accounting standards must be complied with as part of federal securities law.
https://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf, P.50

Thank you!

- Please follow up with any questions.

Water's Edge: Closing the Largest Corporate Tax Loophole in California

Closing the "Water's Edge" Loophole Would Address Offshore Tax Avoidance and Raise $3 Billion in State Revenues

August 2025 | By Kayla Kitson

Corporate profits have skyrocketed in recent years while workers' wages have stagnated and families struggle to keep up with the rising costs of living. Despite these disparities, large tax breaks, such as the "Water's Edge" loophole, remain in place. Big corporations have also benefited greatly from the 2017 Trump tax cuts and stand to receive more benefits from the federal tax package recently signed into law. Corporate tax breaks largely benefit corporate shareholders, who are disproportionately wealthy and white, widening economic and racial inequality.

California policymakers should ensure that profitable corporations pay their fair share in state corporate taxes — which represent a tiny share of their expenses — to support the public services that Californians need. This is especially urgent to help mitigate the harms of the harmful federal cuts to health care, food assistance, and other basic needs programs.

State leaders should end the state's most costly corporate tax break — the water's edge loophole, which allows corporations to avoid around $3 billion in California taxes each year and deprives the state of needed resources to address the most pressing concerns facing Californians.

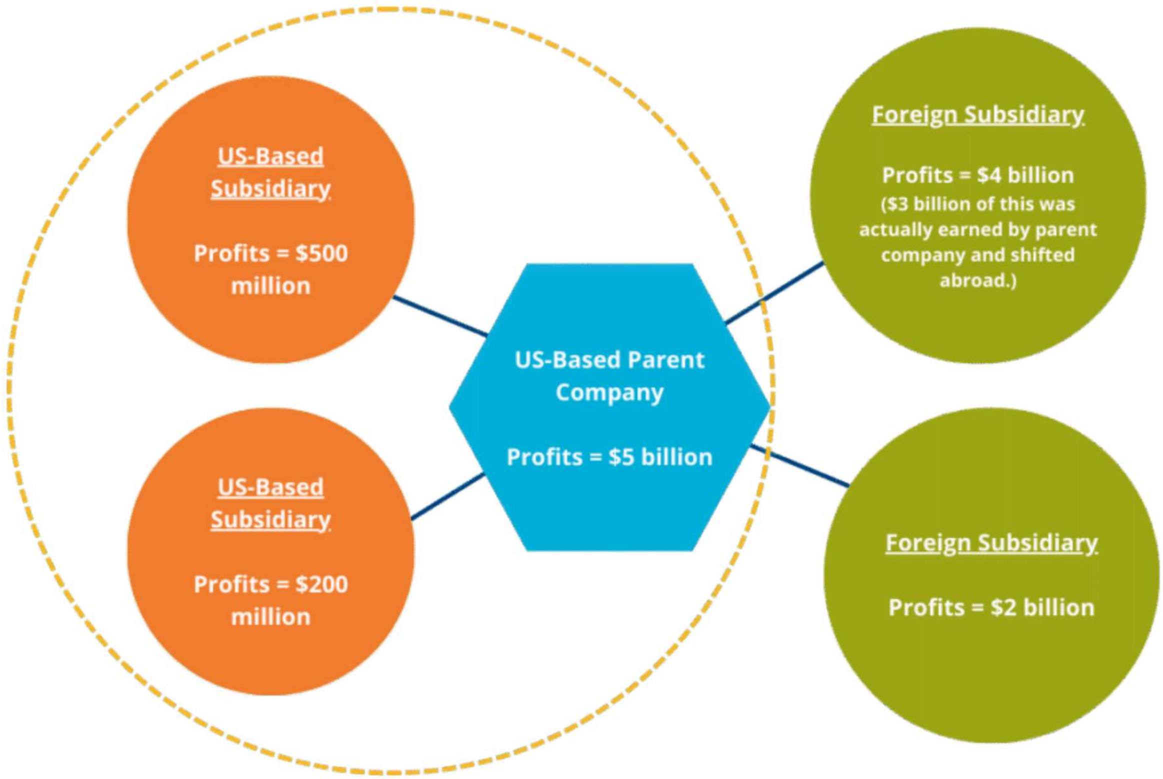
As state leaders look to blunt the harm of the federal budget on Californians with low incomes and the state's finances, it's clear that California's corporate tax structure is in need of repair. While large, profitable corporations benefit from new federal tax breaks, California policymakers must ensure these businesses pay their fair share in state taxes. There is no one-size-fits-all solution: different options can all complement each other. For example, limiting corporate tax credit usage will raise revenues by itself but will also prevent erosion of the revenue potential from ending the water's edge loophole.

The Problem: Multinational Corporations Avoid Billions in State Taxes by Shifting US Profits Offshore

Large corporations that have affiliated companies outside of the US can use a variety of mechanisms to artificially shift hundreds of billions in US profits to foreign jurisdictions with low tax rates — known as tax havens — to reduce their federal and state taxes. In fact, corporations report to federal tax authorities that their profits in some well-known tax havens are multiple times larger than the entire economies of these places, indicating that most if not all of those profits are only there on paper.

As one example of how a corporation might accomplish this, a US corporation can transfer ownership of intellectual property like patents or trademarks to a foreign affiliate and pay the affiliate for the right to use them, effectively moving income off the books of the US corporation while keeping it within the larger corporate group. This is a tactic that industries such as tech and pharmaceuticals can easily employ, but corporations across the board have options to engage in offshore profit shifting and tax avoidance.

Corporations Can Greatly Reduce Profits Subject to Taxation — and Their Taxes — by Shifting Profits Abroad and Using the Water's Edge Election



CORPORATE GROUP TOTAL PROFITS

If the example corporation above uses the default Worldwide Combined Reporting method, all worldwide profits are included: $5B + $500M + $200M + $4B + $2B = $11.7 Billion.

If the corporation chooses to use Water's Edge Election, only domestic profits are included (yellow oval): $5B + $500M + $200M = $5.7 Billion.

Note: This is a simplified example.

California's "water's edge election" allows corporations to choose whether or not to include the profits of their foreign affiliates when they report their total profits that can be divided up among, or "apportioned" to, the states where they are subject to tax.[1]Generally, profits are apportioned to states by multiplying the total profits by the "sales factor", which is determined by dividing the corporation's sales into the state by its total sales. For filers electing the water's edge method, the denominator is only domestic sales.

The water's edge election creates several issues:

- Smaller, domestic businesses likely pay higher shares of their income in taxes than large multinational corporations because they are unable to shift profits overseas.
- Giving corporations the option of two filing methods means they will always choose the one that lowers their tax bill. For corporations with significant offshore profits, the water's edge method will likely result in lower taxes. If corporations have domestic profits and foreign losses, using the "worldwide combined reporting" method — where all worldwide profits and losses are combined — would result in a lower tax bill.
- Allowing corporations to ignore foreign profits can encourage them to shift profits to foreign tax havens and avoid state taxes by using the water's edge election.

Maintaining the water's edge election will cost the state an estimated $3.1 billion in 2024-25, increasing to $3.5 billion by 2026-27, according to the Department of Finance.

The Solution: Close the Water's Edge Loophole and Require Worldwide Combined Reporting

Requiring large multinational corporations to use the worldwide combined reporting method would eliminate the state tax benefit of shifting profits abroad and close this loophole, resulting in additional revenue for California. Under this method, corporations are required to include the income of all their domestic and foreign affiliates in their total profits before determining what share is taxable by each state. This is already the default tax filing method for corporations subject to tax in California that don't elect the water's edge method, so some corporations currently use this method when it is beneficial for them.

In tandem with requiring worldwide combined reporting, policymakers could take steps to prevent corporations from underreporting their sales into California, driving down the "sales factor" used to determine the share of their profits that can be taxed in California, and ultimately reducing their state taxes. For example, policymakers can clarify state law to ensure corporations report the final destination of their sales — not the location of intermediaries — for the purpose of the sales factor, and require more robust reporting on the locations of sales to allow tax authorities to better identify cases when a corporation may be underreporting. This is a reform that should generate additional revenue on its own, but would also help prevent the erosion of revenues that could be gained from requiring worldwide combined reporting, as requiring corporations to report their global profits may lead them to find other ways to reduce their California tax bill, like underreporting sales into the state.

Ending the water's edge loophole for large corporations and requiring worldwide combined reporting is a common-sense reform to ensure corporations contribute a fair share of their profits in California taxes to support the state services and infrastructure that allow companies, their workers, and their consumers to thrive.

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^1 Additionally, while some groups of related corporations may elect to file a group tax return in California, each corporation may file separate returns but are still required to combine profits at the corporate group level first, before apportioning profits between taxing jurisdictions and individual corporate entities.

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Revisiting the Debate Over State Taxation Of Foreign-Source Income

by Karl A. Frieden and Douglas L. Lindholm

Karl A. Frieden

Douglas L. Lindholm

Karl A. Frieden is the vice president and general counsel of the Council On State Taxation. Douglas L. Lindholm served as COST's president and executive director for 25 years and is now special counsel to COST and chair of the advisory board to COST's State Tax Research Institute.

In this article, Frieden and Lindholm explore why it is so important to view proposals to expand foreign-source income inclusion in state corporate income tax bases not in isolation, but as part of the larger fabric of state and local taxation of businesses.

The inclusion of foreign-source income (FSI)[1] in the state corporate income tax (CIT) base consistently ranks as one of the most controversial and hotly debated state tax issues. Over the years, FSI treatment has surfaced numerous times in virtually every state legislature, and parties as diverse as the U.S. Supreme Court, state supreme courts, a U.S. presidential commission, and key foreign trading partners have all weighed in on different elements of the subject.[2] It is our view, however (and the topic of this article), that most legislative examinations of the FSI issue, and particularly those considered after passage of the federal Tax Cuts and Jobs Act in 2017, have failed to consider state taxation of FSI within a broader tax policy context and its impact on state and national economic competitiveness. That failure is creating negative consequences in the state tax arena — ramifications that state policymakers should not ignore.

There's an ancient Buddhist parable called "The Blind Men and the Elephant" that is instructive here. The parable describes the experiences and impressions of four blind men examining an elephant for the first time. One feels the trunk, another a tusk, another the elephant's leg, and the fourth latches on to an ear. Upon later comparison, their subjective interpretations, each undoubtedly correct, differ so greatly that the men come to blows after accusing each other of dishonesty. One of the lessons of the parable, of course, is that unless we examine the entire animal, our selective interpretations of its characteristics are necessarily incomplete.

In considering the merits of FSI inclusion, it is imperative that state legislators and policymakers consider the broader context of state business taxes. Most significant FSI legislative proposals in the last few years have been stand-alone bills with

[1] FSI is taxed by states under many different methods and theories, and may include foreign dividends, income of controlled foreign corporations and 80-20 companies, subpart F income, income from foreign partnerships, income of "tax haven" subsidiaries, global intangible low-taxed income, and implementation of mandatory worldwide combined reporting. All are manifested by inclusion of FSI in a state's (domestic) CIT base.

[2] *See generally* Department of Treasury, "The Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental View" (Aug. 1984); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983); *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

legislative deliberations undertaken in isolation from other state tax policy issues.[3] To rectify this glaring imbalance, any debate over inclusion of FSI in the state CIT base should encompass:

- the recent rapid growth of state CIT revenue without further FSI base inclusion;
- the impact of transformational global tax reform that for the first time is systematically addressing (and reducing) low-taxed FSI through the adoption of a global minimum tax (GMT);
- the need to match increased CIT base inclusion of FSI with a commensurate CIT apportionment formula that requires foreign factor representation; and
- consideration of the design flaws in other state and local taxes that disfavor businesses far more than the CIT design purportedly favors businesses.

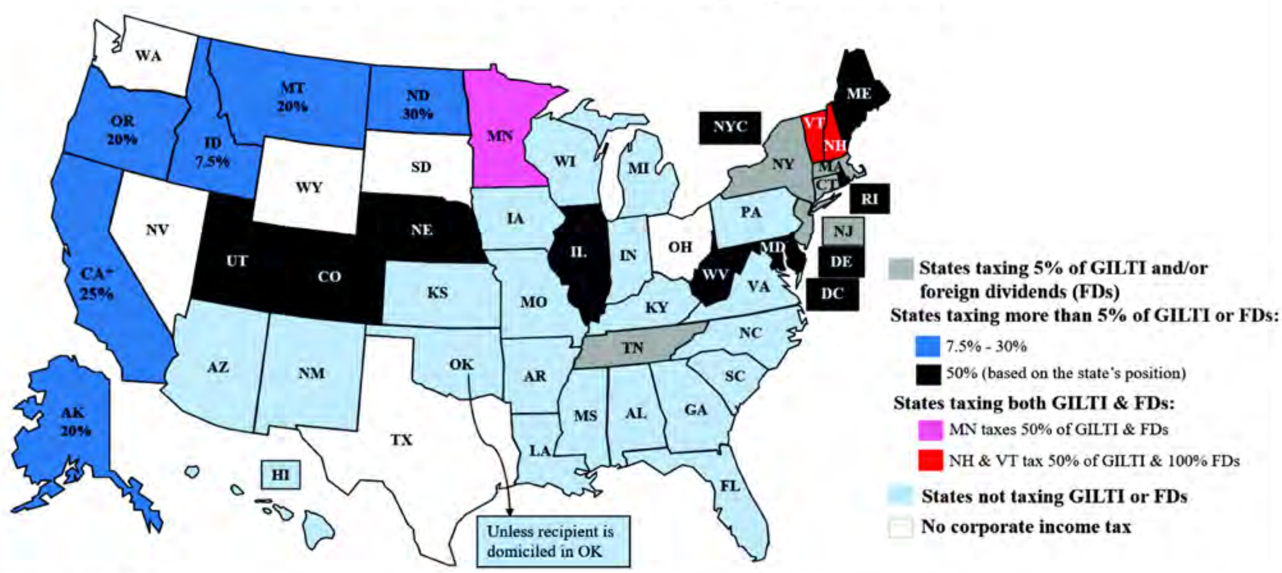
[3]For examples of stand-alone worldwide combined reporting bills, see Connecticut H.B. 5968 (2025); Hawaii H.B. 116 (2025); Maryland S.B. 766 (2024); Minnesota H.F. 1938 (2023); Nebraska L.B. 40 (2024); New Hampshire H.B. 121 (2024); Oregon S.B. 419 (2025); and COST, "Letter in Opposition to Vermont's Efforts to Impose Mandatory Worldwide Combined Reporting" (Feb. 28, 2024).

The Recent History of FSI Legislation

Over the last 40 years, state legislative outcomes on FSI were relatively stable, as most states, especially the most populous ones, generally avoided including FSI in the CIT base.[4] A substantial minority of states, however, included some portion of FSI in the CIT base through a combination of categories encompassing foreign dividends, subpart F income, tax haven subsidiary income, and global intangible low-taxed income. During that time frame, the one significant CIT change was that states that previously included a portion of foreign dividends in the CIT base have switched to include a portion of GILTI in the CIT base (see Figure 1).

[4]States may only include income in the CIT base that has substantial nexus with the state, does not discriminate against interstate commerce, is fairly apportioned, and is fairly related to the services provided by the state to the taxpayer. Further, such inclusion must not create a substantial risk of international multiple taxation, nor prevent the federal government from speaking with one voice when regulating commercial relations with foreign governments. *See Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977); *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). Inclusion of FSI in the state CIT base is frequently challenged for violating one or more of these prongs, generating significant litigation.

Figure 1.
State Taxation of GILTI and Foreign Dividends



** CA taxes 25% of FDs.*
Disclaimer: This map is based on the best available information, but several states do not have clear guidance on GILTI. Therefore, this information should be used for general guidance and not relied upon for compliance.
Source: Council On State Taxation (June 2025).

Despite the relative stability of long-term outcomes, in recent years a rising tide of state legislative proposals have sought to expand state CIT bases to encompass more FSI. While most proposed legislation includes a portion of GILTI in the state CIT base, for the first time in decades, multiple jurisdictions have introduced mandatory worldwide combined reporting (MWWCR) bills, including Connecticut, the District of Columbia, Hawaii, Maryland, Minnesota (almost enacted), Nebraska, New Hampshire, Oregon, Tennessee, and Vermont.[5] Momentum for state-level inclusion of FSI has grown largely because of the extensive publicity surrounding international profit shifting and the enactment of new federal and global measures to address the problem. The primary national solutions include U.S. federal inclusion of a portion of current (GILTI) rather than deferred (foreign dividends) FSI in the CIT base, and the transformational OECD/G20 pillar 2 GMT.

For proponents of MWWCR or inclusion of GILTI in state CIT bases, the justification is twofold: (1) the composition of state CIT bases without FSI inclusion is flawed because it does not adequately address international profit shifting, and (2) states are losing significant CIT revenue (and multinational businesses are not paying their fair share) unless states remedy this structural defect either by adoption of MWWCR or the inclusion of GILTI.[6]

What is largely missing, however, from proponents' justification and advocacy for current MWWCR/GILTI legislative proposals is consideration of state CIT reform in a broader tax policy context. Too often, proponents focus with tunnel vision on this one element of SALT design, divorced from other interconnecting fiscal and tax considerations. To that end, advocates wear their "white hats" and loudly proclaim that the design of state CIT statutes that don't include all or most FSI in the tax base is indicative of state tax laws that unduly favor businesses.[7]

This article explores why it is so important to view proposals to expand FSI inclusion in state CIT bases not in isolation, but as part of the larger fabric of state and local taxation of businesses. First, we look at the robust growth of state CIT revenue in the five years following the passage of the federal TCJA. This state-level revenue spike has resulted in state CIT revenues reaching their highest level in 20 years, relative to both total state and local taxes on businesses, and to GDP. The rapid state CIT revenue growth is often overlooked because of the large shadow cast by the TCJA's substantial federal CIT cuts.

Second, we review the unprecedented global tax reform tackling international profit shifting at a national and not a subnational (state) level. The OECD/G20's pillar 2 GMT in conjunction with the new U.S. GILTI regime is fundamentally altering the treatment of low-taxed income around the world and doing so in a way that is rendering state taxation of FSI both less necessary and potentially harmful to U.S. multinational enterprises.

Third, we examine the tendency of states that include FSI in the CIT base to deny MNEs matching foreign factor representation in the apportionment formula. For the last 40 years, only a small minority of states that tax FSI — either by CIT base inclusion of a portion of foreign dividends or a portion of GILTI — provide full foreign factor representation. The rest provide either no foreign factor representation or only the fraction of it as measured by the net foreign income base inclusion. This method is unfair and potentially unconstitutional. Moreover, it is another example of how FSI is treated in isolation, as if traditional apportionment rules that match base inclusion with factor representation do not apply.

Fourth, we examine the two largest categories of state and local taxes imposed on businesses — the tax on business property and the sales and use tax on business inputs — that together make up nearly three-fifths of all state and local taxes on

[5] *See* Connecticut H.B. 5968 (2025); D.C. "Tax Administration Modernization and Simplification Act of 2022"; Hawaii H.B. 116 (2025); Maryland S.B. 766 (2024); Minnesota H.F. 1938 (2023); Nebraska L.B. 40 (2024); New Hampshire H.B. 121 (2024); Oregon S.B. 419 (2025); Tennessee H.B. 2043 (2024); and COST letter, *supra* note 3.

[6] *See generally* Michael Mazerov, "States Can Fight Corporate Tax Avoidance by Requiring Worldwide Combined Reporting," *Tax Notes State*, July 22, 2024, p. 227; Bruce J. Fort, "State Taxation of MNEs Under the TCJA: It's Time for a Policy Reassessment," *Tax Notes State*, June 17, 2024, p. 845.

[7] For background on whether businesses are paying a fair share of state and local taxes, see Karl A. Frieden, "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes," *Tax Notes State*, Apr. 8, 2024, p. 91; and Frieden, "The Boomerang Effect of the Business 'Fair Share' Tax Debate," *Tax Notes State*, Feb. 10, 2025, p. 405.

businesses. We show how the designs of these taxes significantly disfavor businesses, resulting in several hundred billion dollars more in taxes than businesses would pay under more optimal or neutral designs. And yet the business-unfriendly designs of the largest state and local business taxes are generally ignored during legislative deliberations over the smaller-dollar-value state CIT redesign, skewing the debate away from an informed and balanced approach.

State Taxation of FSI Should Consider Other State CIT Developments

State CITs typically fluctuate from year to year, but over the last five years state CIT revenues have increased faster — both in absolute terms and relative to other state and local business taxes — than at any time during the last 20 years (see Figure 2).[8] State and local CIT collections increased from $65.9 billion in fiscal 2018 to $130.5 billion in fiscal 2023 or by about 63 percent after inflation. This significant CIT increase caused the CIT share of all taxes paid by business to increase from 8.5 percent in fiscal 2018 to 12 percent in fiscal 2023.[9] Over the same five years, state CIT revenues also outpaced GDP growth by more than 50 percent.[10]

This recent, rapid state CIT revenue growth, however, has received scant attention because of its juxtaposition with the well-publicized relative decline of federal CIT revenue following TCJA enactment in 2017 (effective for 2018). One of the centerpieces of the TCJA was the reduction of the federal CIT rate from 35 percent to 21 percent — a 40 percent drop. To partially offset the loss of federal CIT revenue, the corporate tax rate cut was combined with a number of base broadeners (and some base narrowers). The net impact was to reduce baseline federal CIT revenue by about 10 percent over 10 years.[11]

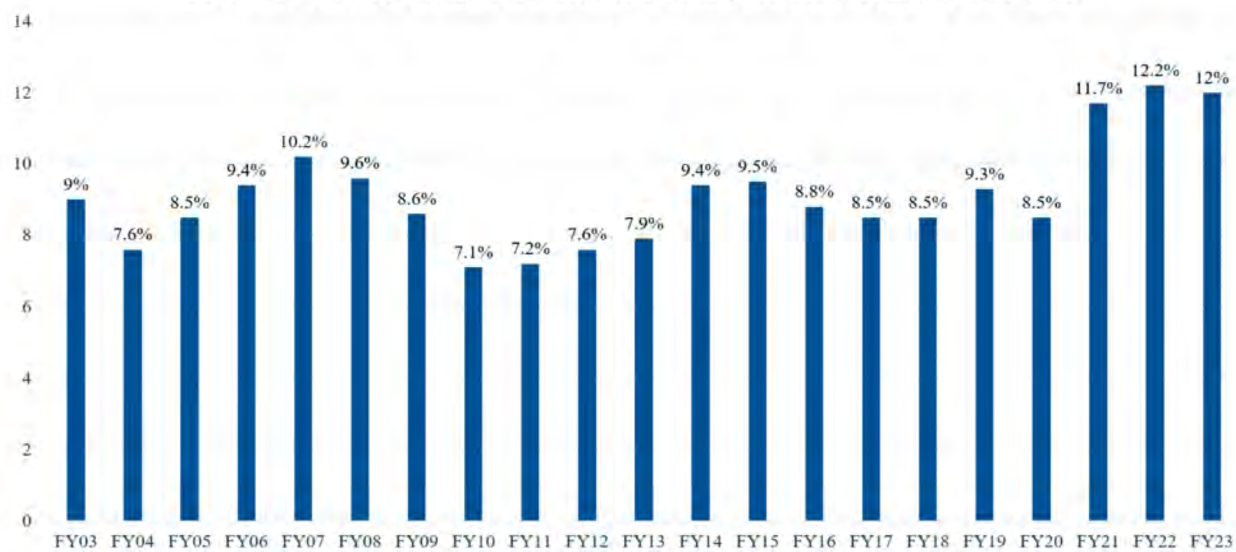
[8] For the 20-year trend, see Figure 2, derived from annual studies: EY, State Tax Research Institute (STRI), and COST, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2002-2023."

[9] EY, STRI, and COST, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2023" (Dec. 2024). EY, STRI, and COST, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2018" (Oct. 2019).

[10] *See* EY, STRI, and COST, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2023," at 21 (Figure 8).

[11] *See* Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, The Tax Cuts and Jobs Act," JCX-67-17 (Dec. 18, 2017).

Figure 2.
Share of CIT in Total State and Local Business Taxes, FY02-FY23



Source: "Total State and Local Business Taxes: State-by-State Estimates," COST/STRI/EY (updated annually).

What was less recognized at the time was that the TCJA had the opposite impact on state CIT revenue. State conformity with TCJA provisions varied significantly; however, no state conformed with the large TCJA federal CIT cut, since states maintain their own CIT rates. Only a small number of states conformed to federal CIT base narrowers (and revenue losers), including accelerated depreciation and the expensing of capital investment. Conversely, most states conformed with some of the largest federal CIT base broadeners (and revenue raisers), including interest deduction limitations (IRC section 163(j)) and the amortization of research and experimentation expenditures.[12]

While state CIT conformity with the federal TCJA provisions was a substantial contributing factor, it was not the most significant one animating the five-year surge of state CIT revenue. Other factors also substantially accelerated state CIT revenue collections, including strong economic growth and corporate profits. For most states, however, conformity with TCJA base broadeners jump-started the surge in CIT revenue with estimated state CIT baseline revenue growth of 12 percent or more.[13]

Moreover, the TCJA-related revenue growth was largely fortuitous. Most states, when given the opportunity, could not turn down the substantial revenue increases derived simply by conforming to federal CIT base broadeners. While few of these states entered 2018 with the legislative resolve to raise state CIT revenue, they could simply do so by conforming to the IRC as they had in the past without designing any new statutory provisions.

The recent upward trajectory of state CIT revenue, however, is almost entirely absent from the analysis of proponents favoring more FSI inclusion in state CIT tax bases. In a June 2024 *Tax Notes State* article, Bruce Fort, senior counsel with the Multistate Tax Commission, encouraged states to reassess state taxation of FSI and to include GILTI in the state CIT base. Fort suggested that federal GILTI revenues were "too big to ignore."[14] The overall impression left by Fort's analysis was that U.S. corporations, especially U.S. MNEs, received more favorable state CIT treatment after the enactment of the TCJA.[15]

However, while advocating for expansion of state CIT bases because of "missing" revenue, Fort almost completely ignores the largely inadvertent "windfall" of state CIT revenue growth attributable to state conformity with TCJA base broadeners. According to the Joint Committee on Taxation, revenue growth (over 10 years) from just two of the largest TCJA base broadeners that most states conformed to (the net interest expense limitations and the amortization of research and experimentation costs) raised about three times as much revenue as federal adoption of the GILTI provision (net of the section 250 deduction).[16]

Similarly, Michael Mazerov, a consultant with the progressive Center on Budget and Policy Priorities, ignored the surge in state CIT revenue in a July 2024 *Tax Notes State* article on MWWCR. Mazerov claimed that states could gain an additional $10 billion to $15 billion in CIT revenue annually if they all adopted MWWCR.[17] In the course of his passionate advocacy for MWWCR, he never once considered whether the timing is appropriate for raising state CIT revenue following so closely the unprecedented — and at least for the TCJA-related portion — unintended surge of state CIT revenue over the last five years.[18]

State CIT revenues fluctuate year-to-year and state-to-state based on both political and economic factors. At a minimum, however, when total state CIT revenues reach their highest levels in the last 20 years both in relation to GDP and

[12] *See generally* Andrew Phillips and Steven Wlodychak, "The Impact of Federal Tax Reform on State Corporate Income Taxes," prepared for STRI by EY, at ii (Mar. 2018); Frieden and Stephanie T. Do, "State Tax Conformity to Key Taxpayer-Favorable Provisions in the CARES Act," *Tax Notes State*, Apr. 20, 2020, p. 303.

[13] Phillips and Wlodychak, *supra* note 12. The EY study estimate was based on historic patterns of state CIT conformity to federal tax base provisions. *Id.*

[14] Fort, *supra* note 6, at 857.

[15] Fort cautioned that "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." *Id.* at 845.

[16] *See* JCT, *supra* note 11; and Phillips and Wlodychak, *supra* note 12, at 4-5.

[17] Mazerov, *supra* note 6, at 236.

[18] *Id.*

relative to other state and local business taxes, debates over new proposals to increase state CIT revenue (through adoption of GILTI or MWWCR) should proceed with caution and heightened scrutiny. This is especially true in a state that experienced a large CIT revenue increase from TCJA conformity intended (at the federal level) to produce the opposite result.[19]

State CIT Base Inclusion of FSI Should Not Be Considered in Isolation From Global and National FSI Solutions

Legislative proposals to redesign the state CIT base to include more FSI should not proceed in isolation from global and national solutions addressing the same issue. The primary justification of advocates for state MWWCR adoption or GILTI inclusion is that some MNEs are engaged in global profit shifting facilitated by moving assets to low-tax nations. In evaluating how to address international profit shifting, however, proponents focus almost exclusively on state-level remedies and largely ignore the more impactful national and global solutions transforming the international tax landscape.

To understand the importance of the global approach it is helpful to review the 11-year history of the OECD base erosion and profit-shifting project. The BEPS project began in 2013 with a primary focus on two challenges to national income tax systems: global profit shifting and the digital economy. In 2015 the OECD issued a 2,000-page report that focused on 15 different "action plans" to address these problems. Some of the proposed solutions were implemented by countries in subsequent years.[20]

After passage of the TCJA, however, the OECD project turned in a different direction, adopting a new approach to low-taxed FSI centered on the implementation of a GMT. The "pillar 2" approach, as it became known, includes a 15 percent minimum tax on the income of large MNEs in every country in which they operate. The GMT, implemented through global anti-base erosion (GLOBE) rules, imposes a rate of at least 15 percent on a multinational group's constituent entities — parents, subsidiaries, branches, or permanent establishments — in every country with a rate below 15 percent by "topping up" the country rate so that the entities' effective tax rate is at least 15 percent.[21]

The right to impose a top-up tax is first granted to the source country — typically either a low-tax-rate country or a higher-tax-rate country with significant tax credits and incentives that bring the ETR below 15 percent (known as the qualified domestic minimum top-up tax). If the source country does not impose the tax, the home country of the parent company can collect the tax by increasing the taxable income of the parent subject to tax (known as the income inclusion rule). Finally, the GMT imposes an undertaxed profit rule that specifies that if neither the source country nor the parent country chooses to impose the top-up tax, the countries in which the MNE's affiliates operate can choose to share the top-up tax that could have been levied in the source country.[22]

GLOBE rules apply only to large MNEs — those corporate groups with revenue exceeding €750 million (approximately $850 million) in two

[19] Fort and Mazerov both make an ancillary argument in support of state taxation of FSI — that the current CIT design favors larger multinational businesses over smaller domestic businesses. Fort, *supra* note 6, at 845; Mazerov, *supra* note 6, at 227. For a critique of their positions, see Frieden, "The Boomerang Effect of the Business 'Fair Share' Tax Debate," *supra* note 7, at 411-413. Available studies suggest that larger businesses are generally not favored by the SALT system compared with smaller or domestic-only businesses. It is common knowledge in the tax community and among tax scholars that most small, medium-size, and even many large businesses do not pay CITs at all but are taxed under more favorable personal income tax passthrough entity (PTE) laws. A PwC study in 2017 found that PTEs comprise about 95 percent of all business entities and generally earn about three-fifths of all business revenue. The study was the first ever to quantify the differences in state effective tax rates on business income earned by C corporations compared with PTEs. The study (based on 2013 data) concluded that the aggregate state-level effective business income tax rate for C corporations (6.1 percent) was 30 percent higher than the aggregate rate for passthrough businesses (4.7 percent). *See* PwC, "Corporate and Pass-Through Business State Income Tax Burdens: Comparing State-Level Income and Effective Tax Rates," prepared for the STRI (Oct. 2017). The rate differential was attributable both to generally lower personal income tax rates for PTEs (than CIT rates for C corporations) and the single level of tax on PTEs. *Id.* A similar federal-level study in 2024 (based on 2021 data) by William G. Gale and Kyle Pomerleau found that the average federal ETR of C corporations exceeds the rate of passthrough businesses by more than 20 percent. The federal-level study found PTEs have had a sizable ETR advantage over C corporations continuously for the last four decades. *See* Gale and Pomerleau, "Efficient and Equitable Income Taxation of the Affluent," *Tax Notes Federal*, Nov. 19, 2024, p. 1409.

[20] OECD, "BEPS Project Explanatory Statement" (2015).

[21] *See* Felix Hugger et al., "The Global Minimum Tax and the Taxation of MNE Profit," OECD Taxation Working Papers (Jan. 2024).

[22] Congressional Research Service, "The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy" (Sept. 2023).

of the previous four years. Pillar 2 does not directly impose a minimum tax rate upon countries that impose a low rate. Under pillar 2, jurisdictions are still free to determine their own tax systems, including whether they have a CIT and the level of their tax rates. However, the operation of the IIR and UTPR allow the home country or the location of affiliates to collect a minimum tax if the source country chooses not to. This, of course, creates an incentive for the source country to impose a tax rate at least as high as the minimum tax under the GLOBE rules.[23]

The pillar 2 provisions thus fundamentally foster tax parity among countries by creating a global framework under which countries can impose additional tax on the low-taxed foreign income of MNEs. In 2021 the pillar 2 GMT approach was approved in principle by 140 nations, including virtually all leading economies in the world.[24] Pillar 2 adoption is not through a multilateral agreement but by individual country adoption. In 2024, the first year of planned GMT implementation, adoption of the provisions of pillar 2 was widespread. To date, about 60 countries have adopted some of the key provisions of pillar 2 or declared their intentions to do so (see Figure 3).[25] Pillar 2 adoption has occurred in both larger high-tax nations such as the members of the European Union; and also in smaller low-tax countries, many of which have operated for years as tax havens, including the Bahamas, Bahrain, Barbados, Bulgaria, Curaçao, Cyprus, Gibraltar, Guernsey, Hong Kong, Ireland, Isle of Man, Jersey, Liechtenstein, Luxembourg, the Netherlands, Singapore, and Switzerland (see Figure 3).[26]

[23] *See* Hugger et al., *supra* note 21. *See also* OECD, "Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two," OECD/G20 Inclusive Framework on BEPS (Oct. 2020).

[24] CRS, *supra* note 22.

[25] PwC's Pillar 2 Country Tracker.

[26] *Id.* OECD researchers have estimated that about half of global profit shifting is attributable to high-tax-rate countries offering credits and incentives that bring the ETR below 15 percent. *See* Hugger, Ana Gonzalez Cabral, and Pierce O'Reilly, "Effective Tax Rates of MNEs: New Evidence on Global Low-Taxed Profit," OECD Taxation Working Paper No. 67 (Nov. 21, 2023).

Figure 3.
The Nations That Have Adopted or Announced Adoption of Some or All the Provisions of the OECD's Pillar 2 Global Minimum Tax

Low-Tax Nations
Bahamas
Bahrain
Barbados
Bulgaria
Curaçao
Cyprus
Gibraltar
Guernsey
Hong Kong
Ireland
Isle of Man
Jersey
Liechtenstein
Luxembourg
The Netherlands
Singapore
Switzerland

Other Nations		
Australia	Indonesia	Romania
Austria	Israel	Slovakia
Belgium	Italy	Slovenia
Brazil	Japan	South Africa
Canada	Kenya	South Korea
Croatia	Kuwait	Spain
Czech Republic	Malaysia	Sweden
Denmark	New Zealand	Thailand
Finland	North Macedonia	Türkiye
France	Norway	United Arab Emirates
Germany	Oman	United Kingdom
Greece	Poland	Vietnam
Hungary	Portugal	Zimbabwe
Iceland	Qatar	

Source: PwC's Pillar Two Country Tracker

The significance of international receptivity to the GMT cannot be overstated. Twelve years after the BEPS project started, the promise of transformative international tax reform has transitioned from hypothetical to real. The adoption of the GMT by many OECD/G20 inclusive framework nations is likely to significantly reduce the incidence and revenue impact of global profit shifting. According to an internal OECD study released in January 2024, because the GMT significantly lessens the incentives to shift profits, it will reduce global profit shifting by nearly 50 percent.[27] More importantly, the percentage of profits in low-tax jurisdictions (those with tax rates below 15 percent) is expected to fall by two-thirds, with a concomitant increase in global CIT revenue of nearly $200 billion.[28] Given the minimum dollar threshold levels for the application of the GLOBE rules, the additional revenue-raising will solely affect large MNEs.

Nor has the U.S. federal government been left behind in the wave of international tax reform that seeks to curtail or eliminate low-taxed global income. To date, the United States has not adopted the pillar 2 GMT, and the Trump administration has announced it has no intention of doing so.[29] Nonetheless, the U.S. government's adoption of GILTI — a form of a GMT — has accelerated international tax reform from a series of BEPS 1.0 solutions with mixed adoption records to a global juggernaut that represents the most massive tax reform over the last century. For most U.S. MNEs, GILTI has an ETR of 13.125 percent (when factoring in the 10.5 percent rate and 80 percent foreign tax credit). But in 2026 the ETR is scheduled to increase to 16.406 percent (when the section 250 deduction is reduced from 50 percent to 37.5 percent).[30]

Given the enormity of the unprecedented global tax reform and the GMT's rapid adoption, do the potential sharp reductions in low-taxed FSI alter the perspective of the proponents of MWWCR or state GILTI inclusion? Not very much. For instance, Mazerov, in his July 2024 *Tax Notes State* article advocating for all states to adopt MWWCR, never once mentions the OECD's pillar 2 GMT and its potentially game-changing reduction of global profit shifting.[31] This omission is particularly surprising since the key rationale behind his passionate advocacy for MWWCR is to reduce international profit shifting.[32]

Moreover, Mazerov wrote his latest MWWCR article in the middle of the very year (2024) that GMT adoption was occurring in dozens of countries around the world (and before the outcome of the U.S. presidential election was known). The pillar 2 GMT is not some futuristic solution that is a pipe dream or on some government wish list. Rather, the GMT is effectively structured to be virtually self-propelling without a broad multilateral agreement.

In his article, Mazerov quotes studies of profit shifting, tax havens, and MNEs' behavior and acts as if these fact patterns are frozen in time, unaffected by changes occurring in the national and global tax arenas.[33] He compares MWWCR favorably to other state-level remedies but completely ignores the much greater potential impact of national- and global-level solutions. It seems implausible to have a current discussion on international profit shifting without factoring in the transformative effort of nations around the

[27] *See* Hugger et al., *supra* note 21.

[28] *Id.* at 52. The incidence and revenue impact of pillar 2 could change if the GMT provisions are altered based on continuing dialogue between adopting and non-adopting nations.

[29] The White House, "The Organization for Economic Co-operation and Development (OECD) Global Tax Deal (Global Tax Deal)" (Jan. 20, 2025).

[30] Frieden and Barbara M. Angus, "Convergence and Divergence of Global and U.S. Tax Policies," *Tax Notes State*, Aug. 30, 2021, p. 955. Under the TCJA, there is a scheduled reduction of the section 250 deduction from 50 percent to 37.5 percent in 2026. This reduction may not occur, however, if 2025 tax legislation under consideration by Congress delays or modifies the change in the section 250 deduction. *See* H.R. 1, One Big Beautiful Bill Act.

[31] Mazerov, *supra* note 6.

[32] *Id.* Mazerov states: "While several alternative approaches to addressing international profit shifting have been adopted or proposed, worldwide combined reporting is a more comprehensive solution, and its legality (unlike some of the alternatives) has been fully established." *Id.* at 228. For a comprehensive critique of MWWCR, see Douglas L. Lindholm and Marilyn A. Wethekam, "Mandatory Worldwide Combined Reporting: Elegant in Theory but Harmful in Implementation," COST/STRI (Mar. 2024).

[33] Lindholm and Wethekam, *supra* note 32.

world to address the problem. With the OECD's study concluding that the GMT will be quite effective in reducing low-taxed FSI, this omission highlights the complete divorce of the proponents of MWWCR and state taxation of GILTI from the broader realities of national and global taxation.[34]

Potential Competitive Disadvantage for U.S. MNEs

The omission in Mazerov's article of any reference to pillar 2's GMT and the anticipated reduction in global profit shifting is perplexing, but it may be intentional. While the proponents of MWWCR rest their advocacy on the need to combat international profit shifting by U.S. MNEs, nothing in the MWWCR formulation addresses profit shifting or low-tax foreign jurisdictions. In fact, the opposite is true, as the MWWCR and state GILTI methods generally apply the same way, whether low-taxed foreign income is reduced by 25 percent, 50 percent, or 75 percent.

The key differentiator between the MWWCR/ state GILTI provisions and pillar 2 GMT/federal GILTI provisions is that the former do not provide a credit for taxes paid to other jurisdictions. The global GMT and federal GILTI provisions both operate in effect as top-up taxes, imposing an additional tax only if the current tax burden on MNEs does not reach a prescribed minimum tax. For the GMT the minimum tax is 15 percent; for the federal GILTI provisions the minimum tax is generally 13.125 percent (potentially increased to 16.406 percent in 2026).

By contrast, the MWWCR/state GILTI methods provide no credit for taxes paid to other foreign jurisdictions. For instance, if a low-tax nation increases the tax on a U.S. MNE from 5 percent to 15 percent, this will generally eliminate any GMT (because the "source" country will now impose a 15 percent tax rate) and any federal GILTI (because the higher FTC will offset the federal tax on FSI). The MWWCR/state GILTI tax calculations, however, may not change at all as they are based on formulary apportionment and do not provide an FTC. Accordingly, if there is an increase in the amount of foreign tax imposed on a U.S. MNE but no change in the sales or other foreign apportionment factors that contribute to the generation of the FSI, there is no reduction in the state income tax paid based on the MWWCR/state GILTI formulas.[35]

This may help explain why Mazerov is not alone in his omission of any reference to the game-changing impact of the GMT in reducing international profit shifting. The same applies to the updated 2025 Institute on Taxation and Economic Policy analysis of state revenue increases from MWWCR.[36] The initial 2019 ITEP study[37] is used by virtually all key MWWCR proponents as the basis for their estimates of state tax revenue increases from MWWCR. Yet the new and revised ITEP study released in February 2025, which concludes that MWWCR will produce somewhat higher state CIT increases than its earlier study, similarly makes no reference to the GMT or its potential impact in significantly reducing international profit shifting.[38]

Neither Mazerov's 2024 article nor the 2025 ITEP study explains why they fail to analyze the impact of transformative global reforms aimed at reducing low-taxed foreign income. Nonetheless, a plausible answer is that the unilateral enactment of MWWCR/state GILTI in individual states does not have a material impact on global profit shifting, nor is it intended to. Rather, it is a way for states to increase CIT revenue even if low-taxed FSI is significantly reduced on a global basis.

Over the last decade, a global consensus has developed that international profit shifting by MNEs is a serious problem assignable to structural deficiencies in national CITs. This consensus is the driving force behind the widespread adoption of pillar 2's GMT. However, the global accord applies to harmonized central government solutions, not

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[34]Similarly, Fort authored his 2024 article advocating for states to expand the CIT base to include GILTI without any mention or analysis of the pillar 2 solutions. In doing so, Fort surveyed only state remedies to address international profit shifting and not national and international solutions. Fort, *supra* note 6.

[35]Joseph X. Donovan et al., "State Taxation of GILTI: Policy and Constitutional Ramifications," *State Tax Notes*, Oct. 22, 2018, p. 315, at 330-334. The problem is generally worse under state GILTI provisions (compared with MWWCR) because most states that tax a portion of GILTI do not provide full foreign factor representation. *See* Figure 4.

[36]Carl Davis, Matt Gardner, and Mazerov, "A Revenue Analysis of Worldwide Combined Reporting in the States," ITEP (Feb. 2025).

[37]Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens," ITEP (2019).

[38]Davis, Gardner, and Mazerov, *supra* note 36.

to unilateral subnational (state) solutions. In previous years no large industrialized nations (other than the United States) have attempted to tax FSI at the state or provincial level.[39] The GMT similarly reflects this pattern, with adoption occurring (outside the United States) only at the national level.[40]

The GMT is structured as a minimum tax floor, not a ceiling. Nonetheless, MNEs headquartered in the United States compete for customers and resources on a global basis. The disharmony of our 50-state subnational tax system already imposes significant compliance and resource burdens on businesses greater than those imposed in countries without subnational taxation of corporate income. The GMT and federal GILTI provisions strike a balance between a higher minimum tax on FSI and relative parity among nations in the rate of the tax. The additional imposition of a subnational CIT on FSI can destabilize this balance.

U.S. national/subnational divergence from the GMT model of a 15 percent top-up tax could create a competitive disadvantage for U.S. MNEs. Foreign MNEs are potentially subject to the 15 percent GMT on their FSI but not to any subnational income tax in their own country.[41] U.S. MNEs are potentially subject to the 15 percent GMT and/or the federal GILTI provisions in addition to any state subnational income tax imposed on FSI.[42] Thus, each state that includes FSI in the CIT base either through an additional GILTI inclusion or by adopting MWWCR may exacerbate the rate differential between U.S. and foreign MNEs. Indeed, the more successful the GMT and federal GILTI are at imposing a minimum tax on MNEs' FSI and reducing profit shifting, the more the threat that MWWCR or state GILTI will result in double taxation of U.S. MNEs.

Granted, the federal and global measures to counteract international profit shifting are still in development and will undoubtedly require significant fine-tuning over time. The GMT establishes a tax floor but by itself doesn't eliminate all profit shifting. The future of the UTPR component of the GMT is still uncertain, given the level of opposition to that part of the plan. Substantive differences between the U.S. GILTI provision and the pillar 2 GMT are problematic to achieving a harmonized global solution. The changes in MNE behavior caused by the new global tax regime are still evolving.[43]

Furthermore, the Trump administration's tax and tariff policies and their impact on FSI remain unclear. On the one hand, the Trump administration has announced it is no longer a participant in pillar 2 and has threatened retaliation if other countries treat U.S. MNEs unfairly. The U.S. House of Representatives recently included in its version of the 2025 budget and tax legislation a retaliatory tax that could be used against other countries. On the other hand, a central part of Trump's "America First" platform is bringing jobs and investment back to the United States, which would also reduce global profit shifting by U.S. MNEs. Finally, a future Democratic administration might reverse course again and follow the lead of the Biden administration in providing support for the pillar 2 GMT.[44]

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[39] PwC, "Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income," prepared for STRI (Nov. 2019). Subnational taxation of corporate income is common in the United States but is not the norm in the other 48 industrialized nations in the OECD, which represent (together with the United States) nearly 90 percent of global GDP. And it is rarer still to identify a country with subnational taxation of corporate income that includes FSI in the subnational tax base. Indeed, of these 48 countries, only eight impose a subnational CIT, and only one of those eight (South Korea) subjects active FSI to subnational taxation (at a low 2.5 percent rate) in one large metropolitan area. In the other seven countries, FSI is either not subject to tax or is 95 percent exempt from taxation at the subnational level. *Id.*

[40] PwC's Pillar 2 Country Tracker, *supra* note 25.

[41] A foreign-headquartered MNE could be subject to MWWCR but not to GILTI, which applies only to U.S. MNEs. However, the foreign-headquartered MNE would be subject to WWCR only on the apportioned share of its U.S. income, not on its FSI earned in other countries.

[42] As noted below, the imposition of the pillar 2 provisions on U.S. MNEs is still in flux given current Trump administration opposition to discriminatory extraterritorial taxes. But even if U.S. MNEs are exempted from the UTPR provision, they could still be subject to the 15 percent qualified domestic minimum top-up tax in the source country.

[43] One possible outcome of the change in global tax rules is that U.S. MNEs will move some foreign operations back to the United States. If this occurs, however, the development also lessens the need for states to tax more FSI, since the state CIT base will expand under current state CIT rules.

[44] The White House, *supra* note 29. A new provision in the House of Representatives 2025 tax legislation would allow retaliation against foreign countries that impose discriminatory taxes on U.S. MNEs. See the new IRC section 899 retaliatory tax plan in H.R. 1, One Big Beautiful Bill Act. Conversely, the other OECD inclusive framework participants have indicated they plan to proceed with the pillar 2 GMT. Keven Pinner, "Work to Continue on OECD Tax Plan Despite U.S. Pullback," *Law360*, Apr. 11, 2025; Sophie Petitjean, "EU Shows Openness but Steadfastness on Pillar 2," *Tax Notes Int'l*, May 14, 2025, p. 1015.

At a minimum, however, before enacting any major change to a state's CIT base (including a switch to MWWCR or a large percentage inclusion of GILTI), a state should take notice that international profit shifting and creation of a level playing field between U.S. and foreign MNEs is already being addressed at the global and national levels. A unilateral state-level solution is unlikely to alter profit shifting and could hinder progress toward a rational global solution, especially given the likely volatility of global tax and trade policy over the next few years. Finally, there is a distinct possibility that any state-level solution could create a competitive disadvantage for U.S. MNEs at a time of significant economic uncertainty.

State Taxation of FSI Should Match CIT Base Inclusion With Foreign Factor Representation

Another significant contextual issue frequently disregarded in the debate over state CIT inclusion of FSI is the requirement to match any CIT base expansion with commensurate foreign factor representation. The litmus test of a well-designed apportionment method is that if a state incorporates new sources of income into the tax base, it should also include the factors that contribute to generating that income in the apportionment formula. As stated in the treatise *State Taxation*, "the factors that are employed to apportion income among the states should reflect the factors that produce the income being apportioned. This virtually axiomatic proposition is also a principle of constitutional law."[45] This principle was enunciated by the Supreme Court in *Container Corp.*: "The factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[46]

The key to this principle is the use of factors of production — initially property, payroll, and sales, but in recent years, increasingly just sales — to apportion income. In terms of the sales factor, this entails including the gross receipts that contribute to income production in the apportionment ratio.

Unfortunately, states have a long history of doing exactly the opposite — adding FSI into the CIT tax base without matching the base expansion with the foreign apportionment factors that helped generate the income. This history dates back to the pre-TCJA years when a significant minority of states taxed a portion of foreign dividends.[47]

Currently, most of the states that tax a portion of GILTI or foreign dividends include only in the sales factor denominator the net GILTI or net foreign dividends amount, and not the total foreign gross receipts contributing to the generation of that income. A small number of states (New Hampshire, Utah, and Vermont) include in the denominator of the sales factor the total foreign gross receipts relating to the FSI (see Figure 4).[48]

The omission of foreign factor representation from state apportionment formulas has recently become more overt and punitive. In three widely publicized FSI legislative proposals — one seriously considered in California and two enacted in Minnesota and Illinois — the statutory language entirely precludes foreign factor representation. In the past, states that provided zero foreign factor representation typically included only a small percentage of FSI in the tax base. For example, Connecticut, Massachusetts, and Tennessee provide no foreign factor representation but include only 5 percent of GILTI and/or foreign dividends in the state CIT base (see Figure 4).[49] However, neither California's proposed legislation nor the enacted legislation in Minnesota and Illinois provides foreign factor representation even though they include about half of MNEs' FSI in the tax base.[50]

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[45] Jerome Hellerstein, Walter Hellerstein, and Andrew Appleby, *State Taxation*, ch. 9C, para. 9.15(1) (2022).

[46] *Container Corp.*, 463 U.S. at 169.

[47] Philips and Wlodychak, *supra* note 12, at 13 (Figure 7).

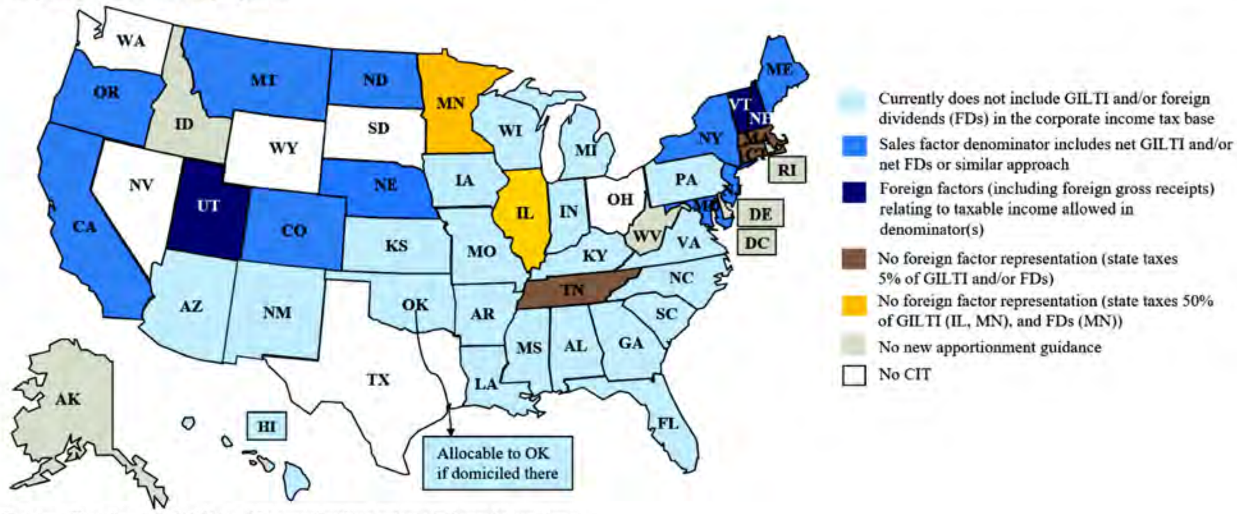
[48] Internal research by COST. *See* Frieden and Fredrick J. Nicely, "Minnesota's New Approach to Taxing Foreign Income Is Unfair and Unwise," *Tax Notes State*, Aug. 21, 2023, p. 583.

[49] *Id.*

[50] On proposed California A.B. 71, see Frieden and Erica S. Kenney, "Eureka Not! California CIT Reform Is Ill-Conceived, Punitive, and Mistimed," *Tax Notes State*, May 24, 2021, p. 795. On Minnesota's enacted legislation (H.F. 1938), see Frieden and Nicely, *supra* note 48. Before the enactment of H.F. 1938, Minnesota provided no foreign factor representation but taxed only 20 percent of foreign dividends and subpart F income. *Id.*

Figure 4.
GILTI and Foreign Dividends State Factor Representation

Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller percentage ownership or personal income tax purposes.



Disclaimer: This information should be used for general guidance and not relied upon for compliance.
Source: COST (June 2025).

The California legislation, A.B. 71, was introduced in the California State Assembly in December 2020. A.B. 71 would have drastically expanded the California inclusion of FSI in the water's-edge combined filer's tax base. First, on a one-time basis, the proposed legislation would require a taxpayer making a water's-edge election to retroactively include 40 percent of its undistributed foreign dividend income from 1986 to 2017 in the tax base (compared with the 25 percent historically included in the California CIT base). At the same time, the legislation prohibited the taxpayer from including in its apportionment formula denominator any of the foreign sales that contributed to the generation of the repatriated income over the 40-year period. Second, on a current basis, A.B. 71 required a taxpayer that makes a water's-edge election to include in the CIT tax base 50 percent of GILTI. Once again, the proposed bill prohibited the taxpayer from including in its apportionment formula any of the foreign sales that contributed to the generation of GILTI earnings.[51] The bill passed several assembly committees before it was rejected by the full assembly because the super majority required for tax increases in California could not be obtained.[52]

In 2023 Minnesota adopted a new statutory approach to taxing FSI that vastly expands the amount of that income in the CIT base. Before the legislation, Minnesota included 20 percent of foreign dividends and subpart F income in its CIT base.[53] Under the new legislation, Minnesota includes (for the first time) 50 percent of GILTI in the CIT base and increases the inclusion of foreign dividends and subpart F income to 50 percent. The significant expansion of FSI in the CIT base was done without providing any factor representation in the apportionment formula for the foreign sales that produced the foreign-source income. Minnesota, the first state to include 50 percent of FSI in the state CIT base with zero factor representation,[54] has now been joined by Illinois.

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[51]Frieden and Kenney, *supra* note 50.

[52]*Id.*

[53]Subpart F income is a category of foreign-source income historically taxed on a current, not deferred, basis under IRC sections 951 and 952. For controlled foreign corporations, subpart F income is generally a small portion of foreign-source income and typically includes "movable"- or "passive investment"-type income. *See* IRS, "Subpart F Overview" (Sept. 3, 2014).

[54]Frieden and Kenney, *supra* note 50.

On May 31, 2025, the Illinois Assembly, in its recently enacted tax omnibus bill (H.B. 2755) included 50 percent of GILTI in the Illinois CIT base. Similar to Minnesota, and different than any other state that includes a substantial portion of FSI in the CIT tax base, Illinois fails to provide any factor representation in the apportionment formula for the foreign sales that produced the foreign-source income.[55]

This new approach to taxing foreign-source income makes Minnesota and Illinois not only anomalies among states, but also outliers compared with the federal income tax scheme under the TCJA. As noted above, the federal government allows taxpayers a credit for 80 percent of foreign taxes paid on GILTI. For federal purposes, the FTC is crucial to avoiding double taxation of FSI. According to a study using IRS Statistics of Income division data, in 2018 — the first year GILTI was in the federal income tax base — the use of the FTC reduced the federal tax on GILTI by approximately 57 percent.[56] Similarly, pillar 2's GMT is a 15 percent top-up tax, which effectively allows a 100 percent FTC by reducing the income subject to tax based on the percent of tax applied in the foreign jurisdiction.[57]

Despite the sharp deviation from the normative apportionment of domestic income, the advocates of FSI base inclusion stoutly defend the zero factor representation as rational tax policy. Their theory is grounded in the notion that up to 50 percent of FSI is not foreign income at all but "displaced domestic income" and therefore requires no additional factor representation.[58]

Whatever one thinks of the debate over international profit shifting and how to address it, this view of FSI is without factual basis and is increasingly obsolete. The purpose of matching base inclusion with factor representation is to allow the apportionment formula to provide a proxy for allocating income to a jurisdiction.[59] The notion that you can somehow arbitrarily determine how much income is domestic and how much is foreign is akin to a "separate accounting" method that the proponents of FSI inclusion typically disparage.[60] The state FSI advocates refuse to acknowledge the obvious — that the allowance of zero or limited foreign factor representation is related to maximizing state CIT revenue, not to providing a fair or constitutionally valid apportionment of in-state income. Indeed, the recent ITEP study on the state revenue impact of MWWCR illustrates this point with its conclusion that Minnesota raises 80 percent more revenue by taxing 50 percent of GILTI with no foreign factor representation than it would with a MWWCR statute that includes 100 percent of FSI in the CIT base with full foreign factor representation.[61]

Moreover, in the context of the widespread adoption of the GMT, this "no foreign factor representation" approach is hopelessly outdated. It operates as if the taxation of FSI is static and no other tax base or rate changes occur elsewhere. By contrast, the pillar 2 GMT and federal GILTI approaches both make allowances for increases in foreign taxes paid on FSI by providing an offset against the GMT rate or a credit against the tax on GILTI.

To be sure, states generally do not use credits for CITs paid to other jurisdictions. But that is the purpose of apportionment formulas — to operate as a proxy for tax credit calculations. When FSI proponents impose their subjective judgment (without factual basis) on what constitutes domestic or foreign income without the aid of traditional apportionment formulas, the outcome is patently unfair, likely unconstitutional, and

[55] Illinois H.B. 2755. The Illinois General Assembly in late May 2025 passed H.B. 2755, which includes 50 percent of GILTI in the CIT base (at 601).

[56] Andrew P. Duxbury, Morgan Whaley, and Irana J. Scott, "Have the TCJA International Provisions Met Revenue Estimates?" *Tax Notes Int'l*, July 31, 2023, p. 541.

[57] CRS, *supra* note 22.

[58] *See* Dan R. Bucks et al., "Weak Corporate Tax Reform Critiques Suggest Serious Debate Isn't Intended," *Tax Notes State*, Oct. 23, 2023, p. 287. The MTC's Bruce Fort adopts a different perspective than some of the other advocates of including more FSI in the CIT base: He endorses foreign factor representation. Fort, *supra* note 6, at 854-855.

[59] For instance, the MTC has a long-standing position that applies full foreign factor representation to FSI. The MTC model combined reporting statute addresses several discrete categories of foreign-source income, including subpart F income earned by foreign subsidiaries, income from so-called 80-20 corporations (with 20 percent or more of their factors in the United States), and income from foreign subsidiaries with income in designated "tax haven" countries. Whenever it requires foreign income inclusion, the MTC model statute requires inclusion in the taxpayer's apportionment calculation of "the apportionment factors related to that income." *See* MTC, "Proposed Model Statute for Combined Reporting," section 5A (as amended by the MTC on July 29, 2011).

[60] *See* Mazerov, *supra* note 6.

[61] Davis, Gardner, and Mazerov, *supra* note 36, at 24 (Figure 5).

puts all of the newly raised CIT revenues at risk in future litigation.[62]

'Fair Share' Arguments for State Taxation of FSI Should Not Be Isolated From a Broader Discussion

The debate over whether business pays a "fair share" of state and local taxes is a fourth sphere in which expanding the CIT base to include more FSI is divorced from the overall fabric of SALT. This disconnect is best illustrated by a critique made by co-author Frieden of the views of a group of leading progressives who, over the last five years, in quarterly roundtables in *Tax Notes State*, have regularly advocated for redesigning the state CIT to include more FSI: Dan Bucks, Peter Enrich, Mazerov, and Darien Shanske (BEMS). BEMS's advocacy is supported by dual principles. First, that business does not pay its fair share of state and local taxes, with a particular emphasis on the CIT as a microcosm of the whole. Second, that this "underpayment" of state and local taxes is the result of flaws in the design of tax statutes that favor businesses.[63]

To rebut the BEMS thesis, Frieden, in an April 2024 *Tax Notes State* article titled "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes" (the Blinders article), asked the following questions: (1) Does the structural design explanation for the business "underpayment" of CIT apply equally to other key state and local taxes imposed on business? (2) If not, is there a quantifiable business "overpayment" of other state and local taxes compared with what businesses would pay with a more optimal or neutral tax design?[64]

The answer, backed by extensive data, is that the designs of the largest state and local taxes disfavor businesses far more than they favor businesses.[65] *First, the tax on business property is the largest of all state and local taxes imposed on businesses, accounting for over one-third of all state and local taxes on businesses.* The property tax design in most jurisdictions significantly favors residential homeowners and disfavors businesses.[66]

Most state property tax laws have statutory exemptions that favor homeowners. These include homestead exemptions, property tax credits, assessment limits, and "circuit breakers" — almost all designed to provide property tax relief for homeowners but not businesses. About half the states impose dual (or split-roll) tax rate classifications that favor homeowners and disfavor businesses. In addition, most states have enacted personal property tax base provisions that disfavor businesses. In sum, property taxes in most states deviate from a neutral tax design, with the average ETRs of the largest categories of business property far exceeding the ETRs on homeowner property.[67]

The sales tax on business inputs is the second largest of all state and local taxes imposed on businesses, accounting for over one-fifth of all state and local taxes on businesses. Sales tax experts widely agree that a well-designed retail sales tax should exempt all or most business inputs to avoid sales tax pyramiding.[68]

The sales tax (in all states where it is levied) deviates significantly from an optimal sales tax model, relying heavily on the inclusion of business inputs in the sales tax base. The extensive taxation of business inputs culminates in a business share of total sales tax collections of about 42 percent. The Blinders article focuses on (and quantifies for the first time) the most clear-cut deviation from an optimally designed sales tax — the pyramided portion of taxable business inputs. Sales tax pyramiding or cascading — when sales tax is imposed more than once on a

[62] *See* Frieden and Donovan, "Where in the World Is Factor Representation for Foreign-Source Income?" *State Tax Notes*, Apr. 15, 2019, p. 199.

[63] Frieden, "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes," *supra* note 7. In keeping with their "fair share" focus, Enrich, Mazerov, and Shanske named their "Model Statute for Worldwide Combined Reporting" the "Fair Share For Billionaire Corporations Act."

[64] Frieden, "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes," *supra* note 7.

[65] *Id. See also* Frieden, "The Boomerang Effect of the Business 'Fair Share' Tax Debate," *supra* note 7. State and local taxes on business property (38 percent), sales tax on business inputs (21.9 percent), and CIT (12 percent) make up 70 percent of total state and local taxes on businesses. EY, COST, and STRI, *supra* note 9, at 5.

[66] Frieden, "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes," *supra* note 7, at 106-112.

[67] *Id.*

[68] *Id.* at 99-106.

related series of transactions — accounts for about half of the dollar value of transactions involving taxable business inputs.[69]

In 2024 EY, in its annual study of "total state and local business taxes" commissioned by the Council On State Taxation/State Tax Research Institute (STRI), added a new section that estimates "excess tax" paid by businesses based on deviations from neutral tax designs.[70] First, regarding property taxes paid by businesses, EY concludes that businesses paid $142.8 billion more in property taxes in fiscal 2023 than they would have if they paid using the average ETR and the personal property tax base that applies to homeowners (see Figure 5).[71] The EY study found that the average ETR on business real property is about 50 percent higher than the average ETR on homeowner real property.[72] The estimate of excess business property taxes constitutes over one-third of the total property taxes paid by business in fiscal 2023.[73]

Regarding the sales tax on business inputs, EY's business taxes study estimates that 49 percent of all sales tax on business inputs represents "pyramided" sales taxes — when taxes are imposed more than once on the same supply chain of goods and services. Based on EY's fiscal 2023 estimate of $240.4 billion of sales taxes paid by businesses on purchases of business inputs, this amounts to $118.1 billion of pyramided taxes (see Figure 5).[74]

[69] *Id.*

[70] *See* EY, COST, and STRI, *supra* note 9, at 26-27 (EY has produced the business taxes study (on behalf of COST/STRI) on an annual basis since fiscal 2002); and COST, COST/STRI Studies, Articles and Reports. EY's estimates are based on expanded data sources and a more comprehensive method than used in the "Blinders" article but derive similar results.

[71] EY, COST, and STRI, *supra* note 9, at 26-27.

[72] *Id.*

[73] *Id.*

[74] *Id.* (The EY estimate of the pyramided share of the sales tax on business inputs is slightly lower than the Blinders article estimate, which was based not on U.S. data but on data from Canada's experience with a national goods and services tax (basically a VAT) and provincial sales and use taxes.); Frieden, "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes," *supra* note 7, at 102).

Figure 5.
Estimated 'Excess' Business Property Taxes and Pyramided Sales Taxes on Business Inputs FY23

Amount the Largest State and Local Business Taxes Exceed Taxes Based on Neutral Tax Designs, FY23 ($ billions)

	Estimated Business Tax Paid (EY)	Estimated Tax if Business Property Is Taxed at Homeowner ETR/ Tax Base; and SUT on Non-Pyramided Business Inputs	Excess Tax Based on Neutral Tax Design
Property Tax on Business Property	$394.3	$251.5	$142.8
Sales Tax on Business Inputs	$240.4	$122.3	$118.1
Total Selected Taxes	$634.7	$373.8	$260.9

Source: "Total State and Local Business Taxes: State-by-State Estimates for FY23," prepared by EY for COST and STRI (Dec. 2024). EY estimates based on data from the Bureau of Economic Analysis, the U.S. Census Bureau Annual Survey of State and Local Government Finances, and the Lincoln Institute of Land Policy/Minnesota Center for Fiscal Excellence 50-state property tax comparison study.

The EY analysis of the two largest state and local taxes paid by business (property taxes and sales taxes on business inputs comprise about three-fifths of all state and local business taxes) concludes that businesses paid about $261 billion more in fiscal 2023 than they would have under neutral tax designs (see Figure 5). This finding, while slightly different in the particulars, is consistent with the Blinders article's conclusion that excess property taxes on business property and pyramided sales tax on business inputs attributable to design flaws that disfavor businesses are far greater than BEMS's claims of business underpayments of CIT arising from design flaws that favor businesses.[75]

In response, Enrich asserts that the strategy of the Blinders article is to divert attention and say: "Stop worrying about the CIT and trying to fix that because businesses are already paying way more than their fair share in other categories."[76] He is half right. We have shown clearly that businesses, using BEMS's own criteria of determining fair share based on deviation from an optimal or neutral tax design, are paying more than their fair share in the largest state and local business tax categories.[77]

But the point here is not that states should ignore the CIT or stop worrying about its design. BEMS raise relevant questions about state CIT design, highlighting a long-standing debate over combined reporting and the inclusion of FSI in the CIT base. However, if BEMS want to push for significant increases in CIT or other business taxes justified by design and fair share arguments, they must expect the business community to insist that the designs of all state and local business taxes are evaluated on a broader basis to determine if they favor or disfavor business.

Conclusion

Currently, advocates of increasing state CIT revenue by including more foreign-source income in the CIT base typically make their case completely divorced from other fiscal, tax, or state and local tax design considerations. Every state has different mixes of budgetary needs, tax composition, and tax designs. Ultimately, state tax policy must focus on state-specific budget and tax considerations. State CIT base expansion legislation should not be considered in isolation from other relevant factors, including:

- other contemporaneous (and very large) increases in state CIT revenue;
- GMT and federal GILTI measures that significantly reduce the impact of international profit shifting and provide relative parity in the treatment of MNEs;
- fair and constitutionally permissible apportionment formulas that provide symmetry between foreign-source income base inclusion and foreign factor representation; and
- other state and local business tax designs that disfavor businesses far more than CIT designs purportedly favor businesses. ■

[75]Frieden, "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes," *supra* note 7, at at 112-114. BEMS allege businesses are underpaying as much as $17 billion in CIT as the result of the absence of MWWCR in all states (*id.* at 98). An updated ITEP study (relied on by BEMS) estimates that state CIT losses due to the absence of MWWCR are $18.7 billion. *See* Davis, Gardner, and Mazerov, *supra* note 36.

[76]Bucks et al., "Incidence Is Not Incidental: A First Response to COST's Flawed Critique," *Tax Notes State*, Oct. 21, 2024, p. 173, at 174-175.

[77]BEMS's primary critique of Frieden's "fair share" argument is that the burden of state and local taxes when the "legal" incidence of the tax falls on business is not fully on businesses because some or most of the "economic" incidence of the taxes is passed on to consumers and workers. *See* Bucks et al., *supra* note 76. For Frieden's detailed rebuttal of BEMS's economic incidence theory, see Frieden, "The Boomerang Effect of the Business 'Fair Share' Tax Debate," *supra* note 7.