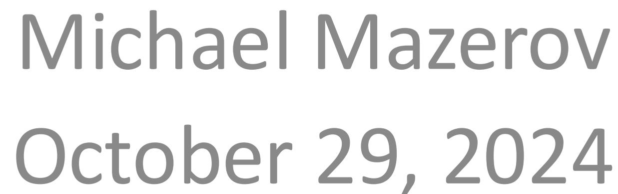
The Case for Worldwide Combined Reporting

And an Initial Response to COST's Case Against It



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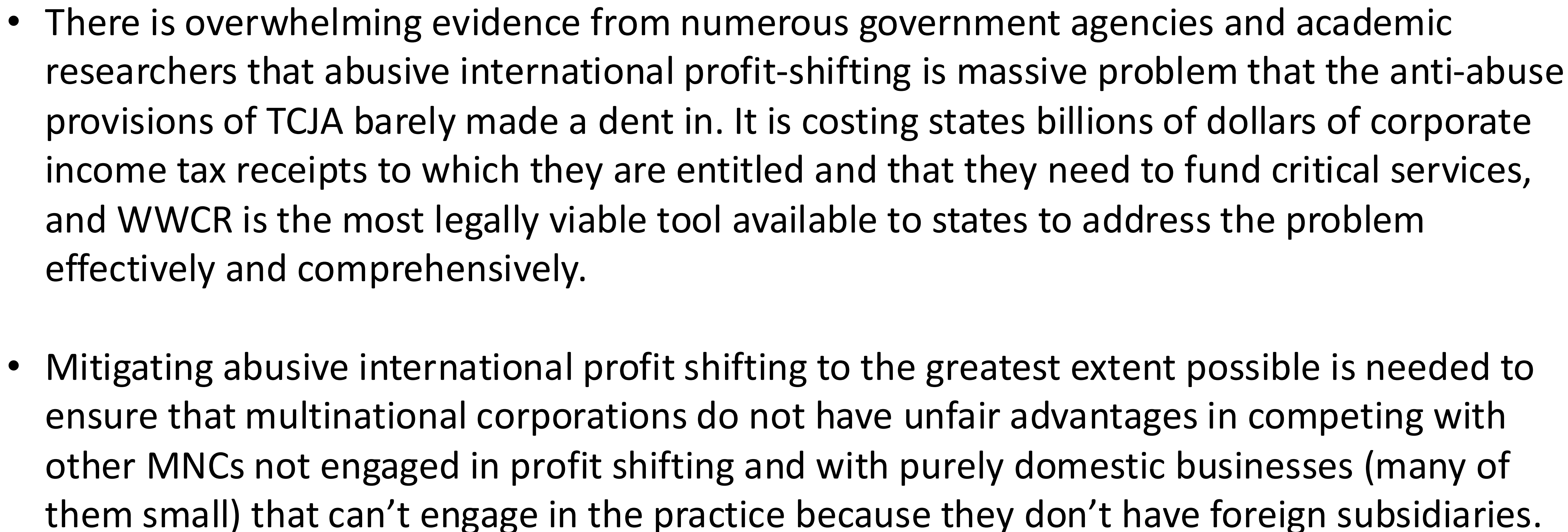
October 29, 2024

Part One:
The Affirmative Case for Worldwide Combined
Reporting

The case for universal state adoption of WWCR in a nutshell



Overwhelming evidence that abusive international profit shifting is pervasive (1)

(For sources, see: Michael Mazerov, "States Can Fight Corporate Tax Avoidance by Requiring Worldwide Combined Reporting," Center on Budget and Policy Priorities, June 27, 2024, https://www.cbpp.org/sites/default/files/6-27-24sfp.pdf . Reprinted in *Tax Notes State*, July 22, 2024.)

- In 2017, international profit shifting just by U.S.-parent MNCs cost the federal government $60 billion to $94 billion in corporate income tax revenue, according to 2020 study by economist and former U.S. Treasury official Kimberly Clausing. "[A]s of the end of 2019, there is no evidence of a reduction in profit shifting" attributable to provisions of TCJA.
- 2023 study by Gabriel Zucman (the other leading academic economic expert) estimated that $369 billion of U.S.-source MNC profit was shifted to 13 tax havens in 2022

Overwhelming evidence that abusive international profit shifting is pervasive (2)

- US Treasury Dept. (2021): "More U.S. profits are housed in tiny tax havens than in the major economies of China, India, Japan, France, Canada, and Germany combined. . . . Despite attempts to rein in profit shifting, tax havens are as available today as they were prior to the 2017 tax reform. For U.S. multinational companies, the share of total foreign income in seven prominent havens is nearly identical in the two years after TCJA (2018 and 2019) as it was in the five years prior to the law, at 61 percent of after-tax income. . ."

- Congressional Research Service (2022): The profit reported by U.S.-parent MNCs as earned in Barbados, Bermuda, the Cayman Islands, Jersey, and Mauritius in 2018 was many times larger than the entire economic output of those countries

Overwhelming evidence that abusive international profit shifting is pervasive (3)

- 76 of the Fortune 100 report in SEC 10-Ks at least one subsidiary in one or more of 9 major foreign tax havens. Walmart has subsidiaries in both the Cayman Islands and Singapore, despite not having stores in either location. Exxon has 6 in Netherlands and 2 in Singapore. CVS has 5 in Bermuda, 2 in Ireland, 1 in Luxembourg, and 1 in Singapore. Johnson & Johnson has 93 tax haven subsidiaries, including 24 in Ireland, 23 in Switzerland, and 19 in Netherlands. HP has subsidiaries in all nine major foreign tax havens, including 26 in Netherlands. Blackstone has 326 subsidiaries in the Cayman Islands and 67 in Luxembourg. Amazon's 10-K reports no foreign subsidiaries, yet its European HQ is in Luxembourg.

Overwhelming evidence that abusive international profit shifting is pervasive (4)

- Series of forensic accounting studies performed since 2020 by transfer pricing economist Stephen L. Curtis and colleagues concluded that just six U.S. MNCs — Apple, Cisco, eBay, Facebook, Google, and Microsoft — may have underpaid their U.S. corporate income taxes by $277 billion (not including penalties/interest) over varying periods from 2009 through 2022 due to their failure to comply with – and the IRS's failure to enforce – IRS regulations regarding cost-sharing arrangements. "If only six taxpayers could represent a half-trillion dollars in collectible funds, it should not be a stretch to believe that total noncompliance could account for as much as $1 trillion or more."
- After a decade of legal wrangling, in 10/23 IRS assessed Microsoft $28.9 billion in additional federal corporate income taxes (plus penalties and interest) for the 2004-2013 period in a challenge to its cost sharing arrangement with a Puerto Rico subsidiary.

Overwhelming evidence that abusive international profit shifting is pervasive (5)

- Economist Brad Setser to Senate Finance Committee (2023): major U.S.-listed pharmaceutical companies reported earning over $90 billion in foreign profits in 2022 but only around $10 billion in U.S. profits. "Such a pattern is all the more striking because the United States is well known to have the highest pharmaceutical prices in the world . . . The cost of pharmaceutical production does not vary significantly from jurisdiction to jurisdiction, so the profit margin on high priced U.S. sales would normally be expected to be much higher than the margin on foreign sales. It consequently is particularly noticeable that the bulk of the American pharmaceutical industry appears to barely make any money on their U.S. operations, while reporting large profits in countries that more intensively regulate pharmaceutical pricing."

How much revenue might states gain by requiring WWCR? (1)

- Inherently extremely challenging to estimate, as indicated by broad range of estimates among academic experts, Congressional Budget Office, etc.

- 2019 study by Institute on Taxation and Economic Policy estimated CIT-levying states in aggregate could gain as much as $17 billion in revenue from universal adoption of WWCR -- $3 billion from remaining separate filing states going first mandating water's edge combined reporting, and then additional $14 billion from all water's edge states then mandating WWCR

- ITEP estimate has been fiercely criticized by COST, Tax Foundation, and WSJ editorial page

How much revenue might states gain by requiring WWCR? (2)

- One criticism is valid: estimate did not acknowledge or adjust for existing inclusion by some states of foreign dividends, Subpart F, and GILTI in their pre-apportionment tax bases. (No data available at the time on aggregate GILTI, but no major states currently include it in any case, so necessary downward adjustments likely to be modest.)

- Most criticisms are not valid: for example, COST study asserts that baseline estimate of aggregate shifted profit upon which ITEP estimate is based represents averaging of Clausing and Zucman estimates, but that is incorrect. Baseline estimate used CBO estimate of aggregate shifted profit, adjusted downward for CBO estimate of how much that would be reduced due to TCJA CIT rate reduction, GILTI, BEAT, etc.

How much revenue might states gain by requiring WWCR? (3)

- Most significant criticism of ITEP estimate is that it failed to dilute foreign profits of U.S.-parent CFCs with their apportionment factors. That criticism is not valid; study essentially relied on a CBO estimate of how much foreign-reported profit would end up in the U.S. tax base after apportionment ($235B).

- If one were going to do an estimate of the revenue gain from WWCR based on diluting foreign income with foreign apportionment factors, one would dilute the total foreign profit of U.S.-parent CFCs, estimated by Zucman to be $799B in 2022 (EU Tax Observatory, Global Tax Evasion Report, 2024, p. 47.) – more than 3 times the amount used by ITEP.

- Moreover, only sales to independent third parties would go into the apportionment factor, and considerable share of CFC sales are to members of same unitary group.

How much revenue might states gain by requiring WWCR? (4)

- Bottom line is that $10B-$15B remains eminently reasonable order-of-magnitude estimate of annual aggregate state CIT revenue loss from international profit shifting
  - ITEP estimate assumed $235B in shifted profit; 2022 Zucman estimate is $369B
  - Neither estimate includes profit shifting out of U.S. by foreign parent MNCs
  - ITEP study estimated CA revenue loss at $2.8B; CA FTB's own estimate is that water's edge election costs state $3.7B
  - 10 states allow water's edge election, which means that companies that pay less under WWCR are already doing so, and revenue effect in those states is all upside
  - No large states are already picking up foreign revenue through GILTI conformity
  - Clausing estimates minimum 20% loss of federal CIT revenue due to profit shifting; given $143B in FY23 state CIT collections, that implies $36B in state losses.

All CIT states should mandate WWCR to help level the playing field (1)

- Not all MNCs have an internal culture that creates pressure for aggressive international tax avoidance, and some lack unique and valuable intangible assets that facilitate it

- Domestic-only corporations – many of them small businesses – don't have the wherewithal to establish foreign tax haven subsidiaries to which they can shift profits.

- But both compete with MNCs that are engaged in aggressive international tax avoidance. (E.g., your local coffee shop doesn't have a Cayman Island subsidiary, but Starbucks does.)

- The international profit shifters may be able to attract capital at a lower cost because of their lower effective tax rates and/or be able to use their lower taxes and pricing power to undercut the prices of their U.S.-only competitors.

All CIT states should mandate WWCR to help level the playing field (2)

- Empirical support: "[T]he empirical analysis also shows that industries with a strong presence of tax-planning multinationals tend to be more concentrated than other industries, but less so when strong rules against tax planning are in place. Overall, the results support the hypothesis that large multinationals use their tax savings to crowd out other firms and ultimately obtain higher mark-ups."

  Sorbe and Johansson, "International Tax Planning, Competition, and Market Structure," OECD Working Paper, 2017

All CIT states should mandate WWCR to help level the playing field (3)

- "A fair and efficient corporate tax system would not favor the biggest and most profitable corporations over smaller domestic competitors. It would also not advantage and reward the most aggressive tax avoiders over those focused on creating economic value. Yet that is the system Minnesota currently has, and so we are pleased to see Minnesota moving towards a reform that would address the unfairness and inefficiency of its current corporate tax system . . . . Worldwide Combined Reporting" (law prof's letter 5/23)

- The ability to lower their U.S. taxes by shifting income offshore "gives US multinational companies a large tax advantage relative to domestic companies, [which] are (on average) far smaller. . . . Reforming international tax rules to ensure that large, dominant multinational companies pay adequate tax on their foreign income is . . . essential for creating a level competitive playing field." (Clausing)

WWCR is the most comprehensive, effective, legally viable state policy for mitigating international profit shifting (1)

- Constitutionality of WWCR has been upheld twice by U.S. Supreme Court as applied to both U.S. parent (*Container*) and foreign parent (*Barclays*) MNCs.

- The only viable legal basis for challenging the application of WWCR is challenging the inclusion of specific affiliates in the unitary group. Contrary to widespread corporate representative assertions, such disputes appear to be exceedingly rare – there is virtually no reported litigation in recent years. States can and should address concerns about unity disputes by allowing (long term and global – i.e., no year-to-year cherry-picking) affiliate group elections based on 50%+ ownership alone (i.e., no requirement for establishment of "unity").

WWCR is the most comprehensive, effective, legally viable state policy for mitigating international profit shifting (2)

- In contrast to the legal viability of WWCR, COST and other corporate representatives constantly rattling sabers about constitutional and other challenges to other anti-profit-shifting policies like GILTI and CAMT conformity, addback statutes, inclusion of tax haven subsidiaries in water's edge groups, etc.

- COST and corporate representatives are also constantly lobbying against the adoption of these alternatives and for their repeal where they exist. (E.g. successful repeal of tax haven blacklists in MT and OR and GILTI conformity and addback provision in NJ)

- Why should states adopt half-measures to address international profit shifting when COST and other corporate representatives will litigate and lobby against them just as systematically and aggressively as they oppose WWCR?

Part Two:

Claim: WWCR proponents are seeking to reestablish a "discredited" policy when there was a "water's-edge compromise" in 1984. (1)

- The WWCR states agreed to withdraw to water's edge combined reporting during the 1984 Working Group because they had a gun to their head in the form of credible threats from the Reagan Administration of federal preemption legislation – not because they agreed WWCR was a "discredited" policy. "Discredited"? -- SCOTUS upheld it twice!

- During the Working Group's deliberations, it was widely conceded that even if states withdrew from WWCR to water's edge combined reporting, they were justified in including foreign tax haven subsidiaries in their water's edge groups. In his final report, Treasury Secretary Regan noted that all five of the alternative water's edge policy "bundles" put forth as potential solutions to the WWCR controversy proposed to include in a water's edge group "certain tax haven corporations presumed to be part of the unitary business." COST omits this fact from its history of the Working Group.

Claim: WWCR proponents are seeking to reestablish a "discredited" policy when there was a "water's-edge compromise" in 1984. (2)

- To this day, COST has a formal policy position opposing state mandating of even water's edge combined reporting and actively lobbies and testifies against its adoption wherever it is proposed – notwithstanding that almost 2/3 of states levying CITs mandate it.

- Notwithstanding the acknowledgment in the Working Group that states were justified in including tax haven subsidiaries in otherwise water's edge combined groups, COST has a formal policy position against this and has actively lobbied for repeal in states that do so and against additional states adopting the practice.

- In short, COST criticizes WWCR proponents for somehow reneging on an alleged "water's edge compromise" that COST <u>itself</u> has <u>never</u> accepted. In any case, international profit-shifting is a far more serious problem today than in 1984; WWCR mandate is justified.

Claim: WWCR is an “outdated” policy.

- No, what is “outdated” is an international income assignment system premised on establishing transfer prices based on an “arm’s-length standard.”

- Such a system might have made sense when it was adopted in the 1930s, when multi-entity MNCs were much less prevalent, international trade was a smaller share of GDP, and most trade was in relatively routine products and commodities.

- Such a system is no longer administrable or capable of preventing massive profit shifting in a world where a huge share of cross-border trade occurs within multi-entity groups and many corporations’ profits are based on highly valuable, unique intangibles and services.

- Key evidence that arm’s length standard is obsolete is need for Pillar 2, GILTI, CAMT

Claim: Corporations opposed WWCR in the early 1980s because of its unreasonable compliance burdens.

- COST: "[S]tate imposition of mandatory WWCR ultimately led to numerous court challenges arising out of the complexity of the compliance burdens, the mismatch of foreign and domestic tax rules and accounting standards, and the foreign policy implications of subjecting international groups to subnational (state) taxation."
- Those were the arguments used in *Container* and *Barclays*.
- The cases arose out of MNCs' desire to not be subject to a taxing method that substantially shut down their international tax avoidance strategies.
- Additionally, foreign-parent MNCs viewed the arm's-length system as the international standard and resented having to comply with a different subnational system in the U.S.

Claim: WWCR is not needed, because Pillar 2 will substantially solve the international profit shifting problem (1)

- There is no guarantee that Pillar 2 will be implemented.
  - House Republican leadership is unalterably opposed to "undertaxed profits rule," a critical component of Pillar 2
  - Unless Democrats win both houses of Congress and presidency, U.S. adoption of Pillar 2 is likely dead for foreseeable future
  - If U.S. does not adopt Pillar 2, the entire agreement could fall apart
  - A lawsuit has been filed challenging the EU's adoption of the "undertaxed profits rule," which, if successful, could cause the entire agreement to unravel

Claim: WWCR is not needed, because Pillar 2 will substantially solve the international profit shifting problem (2)

- Even as COST claims WWCR is not needed because Pillar 2 will substantially solve the international profit shifting problem, many COST members are engaged in litigation aimed at undermining the undertaxed profits rule, a critical Pillar 2 component

  - In 7/24, lawsuit was filed in Belgium's Constitutional Court challenging the legality of the country's adoption of the UTPR
  - That lawsuit has been joined by California Business Roundtable, Kentucky Assn. of Manufacturers, and Arkansas and Kansas Chambers of Commerce
  - Many COST members are also members of those organizations, including Chevron, Pepsico, UPS, Valero, Wells Fargo, Amazon, Walmart, AT&T, Coca-Cola, NextEra, Verizon
  - A successful UTPR challenge in the Constitutional Court could invalidate the UTPR EU-wide, which could then unravel the Pillar 2 agreement completely

Claim: WWCR is not needed, because Pillar 2 will substantially solve the international profit shifting problem (3)

- In support of the claim that adoption of Pillar 2 will substantially solve the international profit shifting problem, COST cites a single OECD study, which, before Pillar 2 has even been implemented, predicts a 50% long-term worldwide reduction in profit shifting

  - Even if this estimate were to pan out, it still leaves a massive profit shifting problem
  - The 50% prediction is a worldwide average estimate. Most countries have effective rates much closer to 15% than the U.S.'s, so most of that 50% likely relates to foreign countries
  - The gap between a 15% worldwide minimum tax and a 21% nominal U.S. federal rate combined with 5%-10% state rates may still be sufficient to incentivize significant profit shifting out of the U.S. We know that many corporations find it worthwhile to engage in substantial tax planning to avoid state CITs alone.

Claim: WWCR is not needed, because Pillar 2 will substantially solve the international profit shifting problem (4)

- This is exactly what states were told during the 1983-84 WWCR Working Group: foreswear WWCR, and the federal government will solve the profit shifting problem and protect your tax bases. It didn't happen then, and there is no guarantee it will happen now. States should solve the problem themselves, with the comprehensive tool the Supreme Court has given them.

COST should come clean: its critique of WWCR is really a critique of formula apportionment. (1)

- COST: “The [WWCR] reporting method dictates that the apportionable tax base must include the income of all unitary affiliates without regard to geographic boundaries or business organization structure.”

- COST: “Formulary apportionment rejects geographical boundaries as a determinant based on the theory that business activities within a state are so intertwined with business activities outside the state that it is not possible to separately quantify the income attributable to each state in which business is transacted.”

- Second quote is accurate characterization of premise of formula apportionment [FA]. FA rejects relevance of interstate and international boundaries equally. COST’s objection to WWCR here is really a rejection of FA. COST fails to explain why MNC’s choice of legal structure should override fundamental economics of the enterprise upon which FA is based.

COST should come clean: its critique of WWCR is really a critique of formula apportionment. (2)

- COST: WWCR is "a filing methodology that required large multinational taxpayers to calculate the precise location of their global economic factors – property, payroll, and sales – as a means of determining how much of the company's global income should be apportioned to a specific state. And this was to be undertaken in the face of <u>differing domestic and foreign accounting principles, exchange rate fluctuations, inflationary differences, differing levels of profitability, and numerous other domestic/foreign distinctions . . .</u>"

- All of the underlined considerations arise in the context of an MNC operating as a single legal entity or having subsidiary legal entities that operate across national boundaries. Raising these issues as an objection to WWCR rather than formula apportionment generally is misleading.

Claim: Complying with mandatory WWCR would be unreasonably complex, burdensome, costly, uncertain, litigious, etc. (1)

- Obviously, MNCs are enormously complex enterprises engaged in enormously complex production processes spanning numerous national borders and employing diverse and complex business models. No method of measuring and allocating their profits across international boundaries can ever be simple.

- But complying with Section 482 is complicated, burdensome, costly, subjective, uncertain, litigious, etc. Complying with GILTI is as well. Complying with the CAMT will be. Complying with Pillar 2 rules will be. Filing a 6-page IRS Form 5471 for every single CFC is undoubtedly complicated, burdensome, and costly.

- Fairly assessing the complexity, subjectivity, burden, etc. of complying with WWCR is a matter of a) "compared to what?" and b) what is the <u>marginal</u> burden of WWCR?

Claim: Complying with mandatory WWCR would be unreasonably complex, burdensome, costly, uncertain, litigious, etc. (2)

- COST and other WWCR opponents can describe in detail the complexities of complying with WWCR because their baseline for such a comparison is a status quo in which there is virtually no independent policy or action by states to protect their corporate income tax bases from abusive international profit shifting.

- They are quite happy with that status quo because it provides MNCs with billions of dollars of state tax savings on top of tens of billions of federal tax savings.

- But that status quo should be unacceptable to states, the public, and competitors not engaged in abusive profit shifting.

Claim: Complying with mandatory WWCR would be unreasonably complex, burdensome, costly, uncertain, litigious, etc. (3)

- It is entirely understandable that COST and other WWCR opponents don’t relish the idea of having to comply with WWCR mandates on top of Section 482, GILTI, CAMT, Pillar 2, and IRS international information-reporting requirements

- They are free at any time to make constructive recommendations regarding how states might mitigate WWCR compliance burdens by piggybacking on GILTI, CAMT, and Pillar 2 calculations and information reporting

- One of the chief objections to the compliance burden and subjectivity entailed in WWCR can be addressed by long-term, global, affiliate group elections based on 50%+ ownership, which I support.

Claim: Complying with mandatory WWCR would be unreasonably complex, burdensome, costly, uncertain, litigious, etc. (4)

- COST: WWCR "was to be undertaken in the face of differing domestic and foreign accounting principles, exchange rate fluctuations, inflationary differences, differing levels of profitability, and numerous other domestic/foreign distinctions that can only be resolved through "best guess" scenarios. Unfortunately, the arbitrary nature of these calculations undermines the requisite certainty and predictability of effective tax statutes, and of the ensuing audits of companies under those statutes."

- U.S. based corporations already have to deal with differing accounting principles, exchange rate changes, subsidiaries organized as passthrough entities, etc. in creating worldwide financial statements for SEC purposes and calculating GILTI and CAMT. Claims that determination of US source income under the arms length standard is more predictable/certain and less arbitrary than the result under WWCR aren't credible.

Claim: Complying with mandatory WWCR would be unreasonably complex, burdensome, costly, uncertain, litigious, etc. (5)

- Whatever the compliance burdens of filing on a WWCR basis may be, hundreds of MNCs are willing to incur those burdens in order to pay less tax in the 10 states that allow a WWCR election

- # of companies making WWCR election 2021 (data gathered from state DoRs)
  - DC – 228
  - MA – 94
  - NJ – 119
  - UT – 500-525
  - MT – 1191 (this is the number known to have foreign subsidiaries)

Claim: Administering/enforcing mandatory WWCR would be unreasonably complicated and burdensome for state tax agencies (1)

- A dozen states mandated WWCR in the early 1980s and believed enough in its benefits relative to its administrative burdens that they agreed to withdraw from it only in the face of threats of federal preemption.

- 10 states currently provide for elective WWCR filing and presumably have significant experience in auditing WWCR returns

- Moving to WWCR would undoubtedly impose significant challenges for state revenue departments; they should be given additional resources to hire additional auditors and obtain training for them, to hire people with federal international tax expertise, to hire attorneys to write regulations and other written guidance, to make necessary changes in IT systems, etc. Revenue gained from WWCR can pay for this.

Claim: Administering/enforcing mandatory WWCR would be unreasonably complicated and burdensome for state tax agencies (2)

- Challenges for state tax departments could be mitigated by:
  - Allowing for affiliate group elections
  - Providing for WWCR effective dates 2 years in the future
  - In the case of separate entity states, having a transition period of water's edge combined filing coupled with temporary GILTI or CAMT conformity to mitigate profit shifting
  - Limiting the application of WWCR to companies subject to CAMT or Pillar 2 combined with permanent GILTI conformity for smaller MNCs