Resurgence of Mandatory Worldwide Combined Reporting

Marilyn A. Wethekam, Of Counsel

Council On State Taxation

122 C. Street, N.W.

Washington DC 20001

312-515-3240

Mwethekam@cost.org

Agenda

- History of Worldwide Combined Reporting
- Global Approach to Profit Shifting
    - Global Approach To Profit Shifting State Response
- Resurgence of Mandatory Worldwide Combined Reporting
- Compliance and Administrative Challenges
- Conclusion

History of Worldwide Combined Reporting

History of Worldwide Combined Reporting

- Commerce Clause and Foreign Commerce Clause Requirements:
  - Commerce Clause - *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977):
    - Substantial nexus
    - Fairly apportioned
    - Not discriminate against interstate commerce
    - Fairly related to services provided by the state
  - Foreign Commerce Clause requirements -*Japan Lines, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1981):
    - States cannot create a substantial risk of international multiple taxation
    - States cannot prevent federal government from speaking with one voice with regard to international relations

History of Worldwide Combined Reporting

- *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983)
  - Container Corp. was headquartered in Chicago Illinois and doing business in California. Container had several foreign subsidiaries and affiliates. The FTB determined the foreign affiliates should be part of Container Corp.'s unitary business. SCOTUS agreed.
    - Container Corp. failed to meet burden to show California's three-factor apportionment formula applied to its unitary worldwide business was not fair.
    - California had no obligation under the Foreign Commerce Clause to use an "arm's length" taxation analysis (employed by the federal government and by most foreign jurisdictions).
    - California's taxation did not violate the "one voice" standard, under which a state tax will be struck down if violative of a clear federal directive or if it implicates foreign policy issues left to the federal government.
      - Risk of international multiple taxation by adoption of combined reporting was constitutionally acceptable.
      - It was not "inevitable".
      - Possibility of multiple taxation exists under arm's-length approach.

History of Worldwide Combined Reporting

- ***Barclays Bank Plc v. Franchise Tax Bd.*, 512 U.S. 298 (1994)**
  - Barclays Group was a multinational banking enterprise including more than 220 corporations in 60 nations, including two corporations doing business in California
  - California sought to determine the liability of the taxable California entities, which Barclays conceded were part of a worldwide unitary business, based on worldwide combined reporting
  - Barclays argued that California was required to use the arm's-length separate accounting method (reflected in U.S. and global income tax regimes) as applied to foreign-based corporations and that failure to do so would violate Commerce Clause restraints applicable to foreign commerce.
  - The Supreme Court applied Commerce Clause scrutiny and the two additional considerations (from *Container Corp.*) for when an income tax affects foreign commerce. A state tax will not survive scrutiny if the tax: (1) applies to an activity lacking substantial nexus with the taxing state; (2) is not fairly apportioned; (3) discriminates against interstate commerce; or (4) is not fairly related to services provided by the state. In addition, when foreign commerce is implicated, the enhanced risk of multiple taxation and whether the state tax impedes the federal government's ability to "speak with one voice" must be considered.
  - The Supreme Court determined:
    - California's system of taxation was Constitutional; and
    - Congress had eleven years since *Container Corp*. to bar worldwide combined reporting and it did not do so.

History of Worldwide Combined Reporting

- Worldwide Unitary Working Group (1984)
  - Governing principles:
    - Water's edge combination for both U.S. and foreign-based companies
    - Increased federal administrative cooperation with the states to promote full taxpayer disclosure and accountability
    - Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses
  - The Working Group failed to reach agreements on:
    - Whether 80-20 companies should be included in combined reports; and
    - Whether foreign source dividends paid by corporations excluded from the combined report should be included in the state tax base
  - Worldwide Unitary Working Group's 1984 Report Recommendations:
    - States should adopt legislation or regulations limiting combined apportionment of both U.S. and foreign-based multinationals to a water's edge group
    - If "there are not sufficient signs of … progress by the states," federal legislation embodying a water's-edge limitation would be recommended
  - The "water's-edge" compromise that resulted from the Worldwide Unitary Working Group has stood for nearly forty years.

Global Approach to Profit Shifting

Global Approach to Profit Shifting

- **Tax Cuts Jobs Act – 2017**
  - The 2017 Tax Cuts and Jobs Act (TCJA) moved the federal system to a "quasi-territorial" system of taxation and lowered the federal corporate income tax rate to 21%.
  - The movement to the "quasi territorial system:
    - Eliminated the taxation of foreign dividends
    - In 2017 imposed a one-time "repatriation tax" on accumulated deferred foreign earnings
    - Instituted a new tax, Global Intangible Low-Taxed Income ("GILTI") on "above routine" profits earned by controlled foreign corporations (measured as excess over a presumed 10% rate of return on depreciable overseas assets) at a reduced tax rate to discourage profit shifting
    - Provided a new deduction, Foreign-Derived Intangible Income ("FDII") for "above routine" profits (measured in a similar fashion to GILTI) for taxpayers selling goods and services to overseas customers
  - TCJA resulted in a significant corporate income tax decrease at the federal level, but an unintended significant corporate income tax increase at the state level.

Global Approach to Profit Shifting

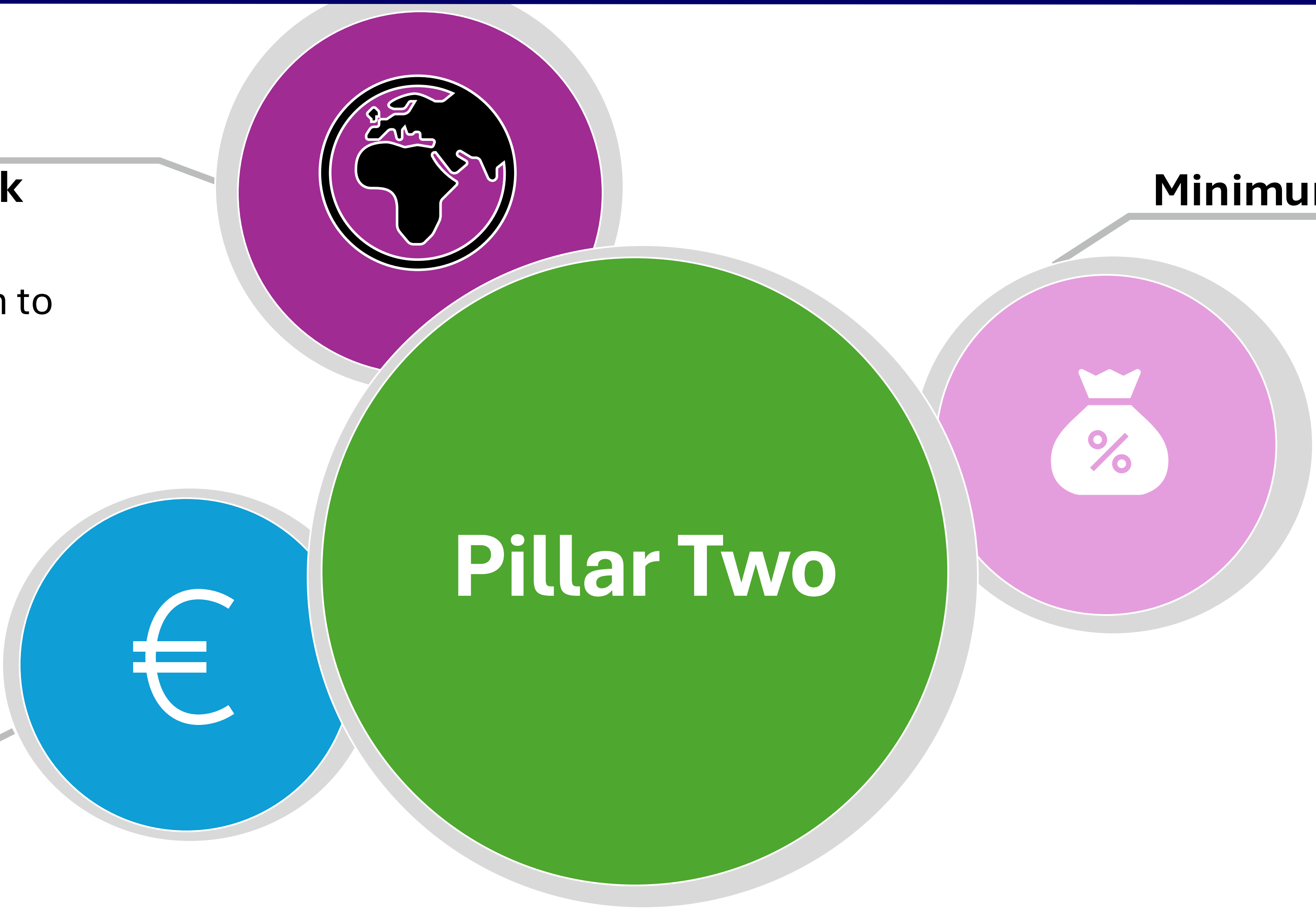
- **The OECD/G-20 BEPS 2.0 Project**
  - Focuses on addressing the tax challenges of the globalization and digitalization of the economy
    - Builds on outcomes of the Base Erosion and Profit Shifting (BEPS) project that culminated in 2015 with final reports on 15 action areas.
  - Pillar One proposes an economic presence and formulaic allocation (market sourcing) approach to increase the taxing rights of market countries
  - Pillar Two proposes global minimum tax rules to ensure cross-border business income is taxed at a minimum rate of 15%

Global Approach to Profit Shifting
What is Pillar 2

“Global” Framework

Global Approach to Profit Shifting

Minimum 15% Tax



Revenue Threshold

Applies to MNEs with consolidated revenue > €750M

Global Approach to Profit Shifting
Pillar 2 Minimum Tax

Priority

- Qualified Domestic Minimum Top-up Tax (QDMTT): In-scope MNE Groups pay a minimum level of tax (15%) to local jurisdiction

Main

- Income Inclusion Rule (IIR): In-scope MNE Groups pay a minimum level of tax (15%) for each country in which they operate at ultimate parent entity level

Backstop

- Undertaxed Profit Rule (UTPR): In-scope MNE Groups pay a minimum level of tax (15%) for each country in which they operate at UTPR entity level, in case no IIR applies

Pillar 2 – Global Overview

Legislation passed / approved

- Austria (Dec 2023)
- Belgium (Dec 2023)
- Bulgaria (Dec 2023)
- Croatia (Dec 2023)
- Czech Republic (Dec 2023)
- Denmark (Dec 2023)
- EU Directive (Dec 2022)
- Finland (Dec 2023)
- France (Dec 2023)
- Germany (Dec 2023)
- Hungary (Nov 2023)
- Ireland (Dec 2023)
- Italy (Dec 2023)
- Japan – IIR (March 2023)
- Liechtenstein (Dec 2023)
- Luxembourg (Dec 2023)
- Malaysia (Dec 2023)
- Malta (Feb 2024)
- Netherlands (Dec 2023)
- Norway (Jan 2024)
- Romania (Dec 2023)
- Slovakia (Dec 2023)
- Slovenia (Dec 2023)
- South Korea (Dec 2022)
- Sweden (Dec 2023)
- Switzerland – DMTT (Dec 2023)
- United Kingdom (June 2023)
- Vietnam (Dec 2023)

Draft legislation released

- Canada (Aug 2023)
- Cyprus (Oct 2023)
- Estonia (Dec 2023)
- Greece (Feb 2024)
- Latvia (Dec 2023)
- Lithuania (Oct 2023)
- N. Zealand (May 2023)
- Qatar (Feb 2024)
- S. Africa (Feb 2024)
- Spain (Dec 2023)
- Thailand (March 2024)

IIR (2024)

- Australia
- Canada
- EU – potential deferrals where few UPEs
- Japan
- Liechtenstein
- Norway
- South Africa
- South Korea
- United Kingdom
- Vietnam

IIR (2025)

- Channel Islands (Guernsey and Jersey) and Isle of Man
- Hong Kong (SAR), China
- Malaysia
- Singapore
- Thailand

UTPR (2025)

- Australia
- Canada
- EU – potential deferrals where few UPEs
- Hong Kong (SAR), China
- Liechtenstein (?)
- New Zealand
- Norway (?)
- South Korea
- Thailand
- United Kingdom

QDMTT (2024)

- Austria
- Australia
- Barbados
- Belgium
- Bulgaria
- Canada
- Croatia
- Czech Republic
- Denmark
- Finland
- France
- Germany
- Gibraltar
- Greece
- Hungary
- Ireland
- Italy
- Liechtenstein
- Luxembourg
- Netherlands
- Norway
- Qatar (?)
- Romania
- Slovakia
- Slovenia
- South Africa
- Spain
- Sweden
- Switzerland
- United Kingdom
- Vietnam
- Zimbabwe

QDMTT (2025)

- Cyprus
- Channel Islands and Isle of Man
- Hong Kong (SAR), China
- Lithuania
- Malaysia
- Singapore
- Thailand

Intention to apply IIR and UTPR (timing uncertain/deferred)

- Estonia (deferral 2030)
- Gibraltar
- Indonesia
- Japan (UTPR)
- Latvia (deferral 2030)
- Lithuania (deferral)
- Malaysia (UTPR)
- Mexico
- Singapore
- Slovakia (deferral)
- Switzerland
- UAE

Intention to apply QDMTT (timing uncertain)

- Bahamas
- EU (optional)
- Indonesia
- Jamaica
- Japan
- Mauritius
- Ukraine

Other related announcements

- Bahrain – Considering the introduction of a CIT as part of its commitment to the OECD minimum tax
- Barbados – Plans to introduce a 9% CIT
- Bermuda – CIT (15%) introduced in response to the OECD Pillar Two initiative
- Colombia 2022 tax reform – 15% minimum tax
- Curacao – Policy measures to address impact of Pillar Two under consideration
- Gibraltar – Policy measures to address impact of Pillar Two under consideration
- Isle of Man – Temporary increase of CIT rate to 15% for certain Pillar Two impacted businesses
- Kenya – Plans to review DST and to adopt two-pillar solution
- Kuwait – Plans to introduce a 15% business profit tax
- Nigeria – Policy measures to address impact of Pillar Two under consideration
- Puerto Rico - Draft legislation aiming to introduce an election to pay 15% minimum tax
- UAE new corporate tax 9%
- U.S. corporate alternative minimum tax enacted 15% (not Pillar Two compliant)
- U.S. Republican Committee introduced two bills with UTPR defensive measure

Global Approach To Profit Shifting State Response

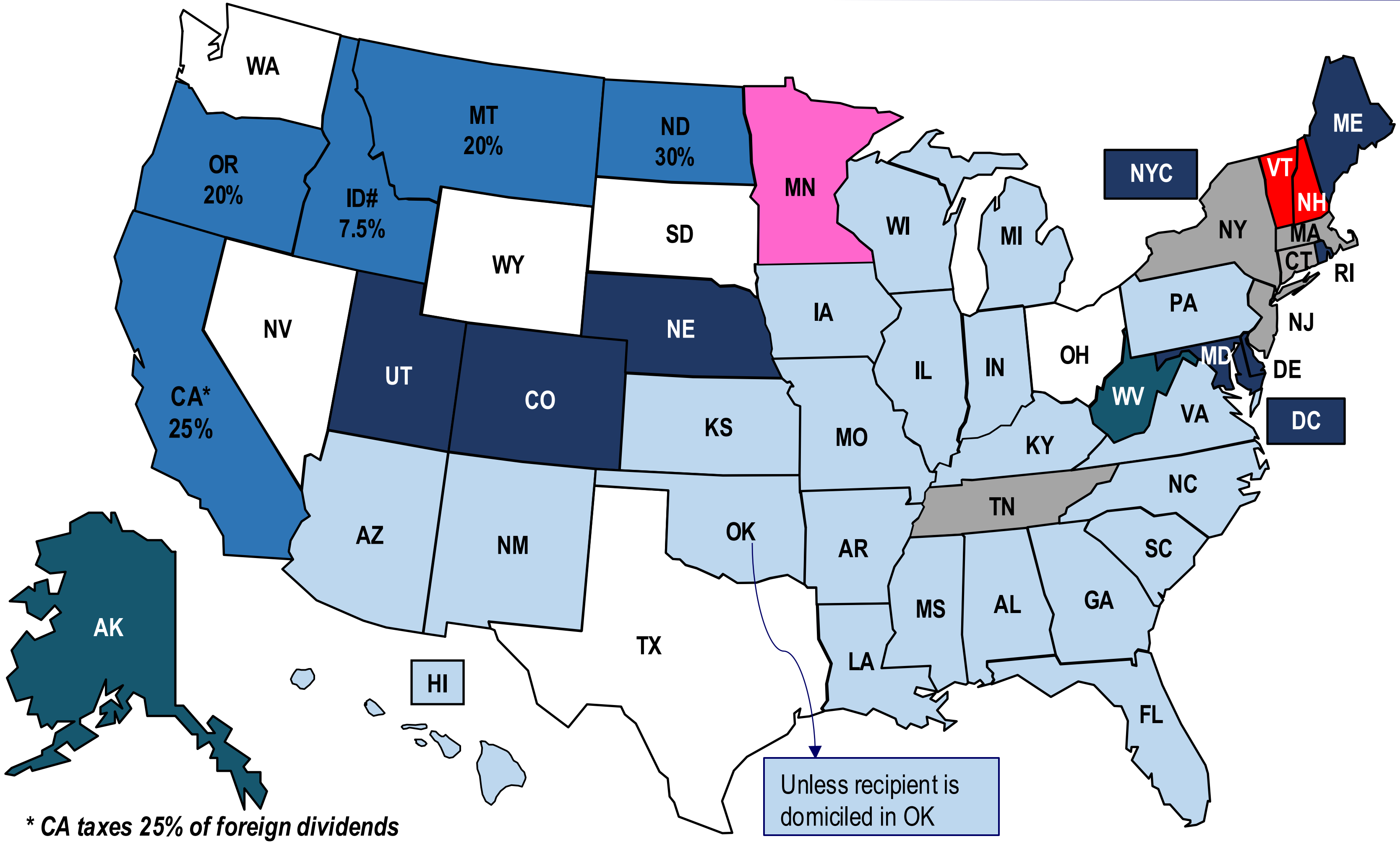
- Federal treatment of GILTI
    - U.S. corporation must include income certain income of a foreign corporation affiliate that is taxed abroad at a rate lower than the U.S. rate and that exceeds a 10% return on the affiliate's tangible property. IRC §951A.
    - U.S. parent can deduct 50% of its GILTI (thereby reducing the effective tax rate on it.) IRC §250(a)(1)(B).
    - Partial foreign tax credit (80%) allowed to lessen tax imposed on GILTI to tax only income generated in law-tax jurisdictions.
        - Foreign tax credit eliminates the potential for double taxation

- State treatment of GILTI
    - Unless the state provides for a special deduction GILTI is included in state taxable income.
        - Some states have decoupled from the provision allowing for the 50% deduction provided for under IRC §250(a)(1)(B).
        - Is GILTI treated as a dividend for DRD purposes?
    - No provision for the 80% foreign tax credit.
    - Apportionment of GILTI:
        - 3 basic categories
            - No factor representation;
            - Allows net foreign source income to be included in the factor, or
            - No guidance has been provided
        - Apportionment mitigates the double taxation issue.
    - Possible discrimination: in a combined return if a state allows for factor representation for similarly situated domestic income.

Global Approach To Profit Shifting
State Response

- Taxation of Foreign Source Dividends
  - State treatment of foreign dividends:
    - Some states may allow the deduction for dividends received from a foreign entity if the foreign payor conducts a unitary operation with the recipient and filed as part of a combined return.
      - California has addressed this issue by allowing U.S. based corporations that make the water's edge election a deduction for qualifying dividends.
        - To qualify, the dividend must be received by a member of the water's-edge group from a payor with an average of less that 20% property, payroll, and sales within the U.S.
        - Must be more than 50% ownership of payor by water's edge group.
        - Dividends classified into first-tier and second-tier.
    - If foreign dividends are subject to tax the apportionment factors should reflect the factors that produced the dividend income.

State Taxation of GILTI and Foreign Dividends



States Taxing 5% of GILTI and/or Foreign Dividends (FDs)

States Taxing More Than 5% of GILTI or FDs:

- 7.5% - 30%
- 50% (Based on the State's Position)
- State Guidance is Unclear

States Taxing Both GILTI & FDs:

- MN: Taxes 50% of GILTI & FDs
- NH & VT Tax 50% of GILTI & 100% FDs

States Not Taxing GILTI or FDs

No Corporate Income Tax

** CA taxes 25% of foreign dividends*

***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 (August 2023)

Global Approach To Profit Shifting State Response

- **Subpart F Income:**
  - General State Treatment
    - U.S. shareholders of foreign controlled corporations (CFCs) may be required to include a portion of the foreign entity's undistributed earnings in their federal taxable income. This deemed income is commonly referred to as Subpart F income
    - For state tax purposes, if the state starts with federal taxable income, the "deemed" dividend will be included in the state tax base.
    - Some states provide a specific deduction for Subpart F income or include Subpart F income as a dividend eligible for a dividends received deduction
    - Several states tax a portion or all of Subpart F income, ex. California and New Mexico.
    - The apportionment formula should reflect the factors that are related to the production of the Subpart F income.

Global Approach To Profit Shifting State Response Treatment of 80/20 Companies

- States may include in a water's-edge combined report a unitary non-US corporation if there are certain activity thresholds in the US.
  - Generally, if less than 20% of its activity is within the US the entity will be excluded from the return. (i.e., 80% or more of its activity is outside the US). The thresholds that may be based on:
    - The average of the corporation's property and payroll factors. (*e.g.* Illinois, Montana and North Dakota)
    - The average of the corporation's property, payroll and sales factors (*e.g.*, California).
    - Whether the corporation has less than 80% "active foreign business income" (*e.g.* Wisconsin).
    - Whether the corporation has less than 80% of its sales factors outside the US (*e.g.*, Rhode Island).

- The taxation of a non-US corporation included under "80/20" company rules varies.
  - Montana - the income of an "80/20" company is treated as a deemed dividend subject to an 80% DRD.
  - Wisconsin - a non-US corporation that is not an "80/20" company may be included in the combined return to the extent of its taxable US source income (and its apportionment factors related to that income are included in the group return.).
- States may exclude US corporations from a water's-edge combined return if the activity thresholds are met
  - Exclude U.S. incorporated entities from the 80/20 rule for the water's-edge election. (*e.g.* New Mexico)

Resurgence of Mandatory Worldwide Combined Reporting

Resurgence of Mandatory Worldwide Combined Reporting

- One of the primary justifications for the mandatory worldwide combined reporting (MWWCR) resurgence: Allow the states to recoup revenues ostensibly “lost” through global profit shifting.
- The resurgence of the effort to adopt MWWCR fails to take into consideration:
  - The alternative efforts started a decade ago by the international tax community, led by the OECD to collaboratively address and combat the growth in global profit shifting.
    - The impact of the imposition of the Pillar 2 Global Minimum Tax
  - The fact states currently tax significant portions of foreign source income.
  - The enactment of add back statutes.
  - The compliance and administrative burdens imposed by MWWCR on both multinational taxpayers and state departments of revenue.
  - The state revenue estimates associated with the justification for the adoption of MWWCR are based on faulty economic assumptions.

Resurgence of Mandatory Worldwide Combined Reporting

- Rationale for the resurgence of the effort to adopt MWWCR
  - The OECD's issuance of the BEPS Action Plan designed to address base erosion and profit shifting activity of multinational enterprises.
    - The goal to close the gaps that had emerged in the international tax system.
  - U.S. revenue estimate on the impact of global profit shifting are uncertain. The result, uncertain revenues for the states.
    - The studies attempting to compute the revenue estimates are complicated by:
      - The use of different data sets, *e.g.* financial reporting data versus tax data.
      - Differing economic analytical approaches.
      - The difficulty in segregating profit shifting among jurisdictions outside the United States and profits that have been shifted from the United States.
      - The difficulty in identifying true profit shifting from revenue foregone in high tax jurisdiction due to incentives offered by those jurisdiction. See: "*OECD Taxation Working Paper No.67, Effective Tax Rates of MNEs New Evidence on the global low taxed profits*" Felix Hugger, Ana Cinta Gonzalez Cobral & Pierce O'Reilly.
      - The difficulty in identifying the true economic activity carried out in low tax jurisdictions from shifted profits.

Resurgence of Mandatory Worldwide Combined Reporting

- The resurgence of MWWCR at the state level is based in significant part on a January 2019 report issued by Institute on Taxation and Economic Policy (ITEP) and U.S. PIRG Education Fund.
  - *"Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens"*
- The reliance on the 2019 ITEP Report's revenue estimate is flawed:
  - The ITEP Report's revenue estimate starting point was $235 billion. The starting point was based on the mid-point of estimates by Professor Gabriel Zucman ($142 billion) *"The Missing Profits of Nations", National Bureau of Economic Research, July 2018.* and Professor Kimberly Clausing (approx. $300 billion) "*Profit Shifting Before and After the Tax Cuts and Jobs Act",* Reed College Department of Economics October 29, 2018 .
    - The Clausing estimate was found to be overstated by approximately two-thirds. Professors Leslie Robinson (Dartmouth Tuck School of Business) and Jennifer Bilouin (Warton) "*Double Counting Accounting: How Much Profit of Multinational Enterprises is Really in Tax Havens"*
    - Professor Clausing has revised her estimate downward to approximately $100 billion noting it could be as low as $61 billion. *"How Big is Profit Shifting"* Kimberly A. Clausing, Thormund A. Miller & Walter Mintz Professor of Economics Reed College. May 17, 2020.

Resurgence of Mandatory Worldwide Combined Reporting

- The allocation of the estimated “lost” revenue to the states is flawed:
  - The Report assigns the income perceived shifted using the state’s average share of gross domestic profit. This method fails to take into consideration:
    - The factors of the foreign entities that generated the income being included in the tax base must be included in the in the computation of the denominator of apportionment formula.
      - The result is a significant dilution of the apportionment percentage.
  - The Report fails to account for the fact a significant amount of foreign source income is currently being taxed at the state level.
    - The result is the double counting of foreign source income.
  - The Report indicates that of the $17 billion of lost revenue, $2.85 billion is a result of separate reporting states adopting combined reporting.
    - The $2.85 billion estimate fails to account for the revenue currently being captured by these states under addback statutes. Again, the result is double counting.
  - The Report ignores the fact that not all foreign source income is “displaced domestic income”.

Resurgence of Mandatory Worldwide Combined Reporting

- Economic Development Considerations:
  - Tax collections will be subject to the volitivity of the global economic markets.
  - The enactment of MWWCR could jeopardize economic development opportunities through direct foreign investment.
    - To many international companies seeking to invest in the United States, adoption of MWWCR sends up a warning flag that the state is potentially an unfriendly environment for business expansion and investment.
  - See: *Mandatory Worldwide Combined Reporting: Elegant in Theory but Harmful in Implementation*, by Douglas L. Lindholm and Marilyn A. Wethekam – March 2024

Compliance and Administrative Challenges

Compliance Challenges

- Taxpayer Compliance Challenges:
  - Worldwide combined reporting is complex:
    - WWCR requires extensive fact-finding to determine the composition of the global "unitary group" .
      - A unitary analysis is required of all affiliates. At its most basic level, the analysis requires:
        - Documentation related to business activities, management structure, and financial polices.
        - Understanding of foreign governance and entity formation rules.
        - Treatment of pass-thru entities.
    - Computation of worldwide apportionable income:
      - Conversion to pro-forma federal taxable income for all foreign entities.
        - Foreign currency exchange issues including timing and rates.
        - Understanding of the difference between financial accounting (IFRS and GAAP) and federal tax accounting methods.
        - Computing state specific modifications for foreign entities.
        - Application of federal consolidated return rules to foreign affiliates and the resulting adjustments..
        - Adjustments to domestic apportionable income to avoid double counting of GILTI or other foreign source income.
        - The utilization of tax attributes such as credits and net operating losses.

Compliance Challenges

- Taxpayer Compliance Challenges:
  - Worldwide combined reporting is complex:
    - Computation of the apportionment formula:
      - Most states have adopted a single sales factor apportionment regime giving rise to timing differences, exchange rate issues, and inflationary differences in foreign jurisdictions.
      - Separate entity versus combined approach,, *e.g. Joyce v. Finnigan*.
      - Application of P.L. 86-272 safe harbors to foreign entities and the implications for the throwback and throwout rules.
      - Application on a global basis of the numerous market-based sourcing methods.
    - Administrative issues:
      - Is the parent corporation the agent of its affiliates for purposes of making elections, signing returns, extending the statute of limitations or executing power of attorney?
  - The complexity results in unnecessary and significant compliance costs not only for taxpayers but also for the State.

Audit and Administrative Challenges

- State tax administrators' challenges :
  - State Tax Departments will be required to retool
    - Auditors will be required to evaluate the composition of the worldwide unitary group.
      - The auditor must understand the entity's global business structure and business activities.
      - The evaluation requires additional documentation review and an understanding of foreign governance rules for entity structures.
    - Auditors will be required to verify taxable income and apportionment percentages:
      - Requires an understanding of foreign financial accounting rules to verify the worldwide income computation as well as the computation of the apportionment percentage.
      - State specific addition and subtraction modification will be applied to the foreign affiliates requiring auditors for example to understand foreign tax structures in determine whether the foreign tax is one that is not deductible.
    - The additional audit review required will extend the competition time for audits.
    - Additional costs incurred to retool.

Conclusion

- Mandatory worldwide combined reporting was abandoned more than 40 years ago.
  - Threats of retaliatory taxation by U.S. trading partners
  - Potential for double taxation
  - Complexities with compliance for both taxpayers and tax administrators
- Base erosion and profit shifting are being addressed on a global basis.
  - OECD's 2015 BEPS project
  - Pillar 2 and the Global Minimum Tax
  - OECD's transfer pricing rules
- The U.S. has shifted to a quasi–territorial tax system - TCJA
  - The inclusion in the corporate tax base of 50% of global intangibles low taxed income. (GILTI)
- State taxation of foreign source income
  - Foreign dividends
  - Subpart F
  - GILTI
- State addback statutes