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Reforming Minnesota's Tax Treatment of Foreign Subsidiaries of U.S. Corporations

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The Center on Budget and Policy Priorities[1] appreciates the opportunity to submit testimony for the record in support of current proposals to reform Minnesota's tax treatment of foreign subsidiaries of U.S. corporations. These proposals include:

- repealing the special tax status of foreign operating corporations (FOCs),
- repealing the deduction for royalties that a U.S. parent corporation receives from a foreign subsidiary or an FOC, and
- requiring corporations to include in their unitary combined reporting groups any corporate subsidiaries formed in foreign countries recognized as tax havens.

Taken together, these three provisions would reduce tax avoidance and evasion, promote fairer competition between in-state and multinational firms, and raise revenue to support public investments that promote economic growth. More specifically:

- They would curtail the ability of corporations subject to Minnesota's corporate franchise tax to reduce their tax liabilities by engaging in artificial transactions – or legitimate transactions at artificial prices – with foreign subsidiaries, often located in countries with very low tax rates.

- By reducing multinationals' ability to artificially shift profits earned in Minnesota to other states or countries, they would help ensure that such corporations' effective tax rate is more comparable to that of in-state corporations, allowing the latter to compete on a more level playing field.

- These changes are consistent with long-standing and widely accepted principles governing the application of state corporate income taxes to multinational corporations composed of a

[1] The Center is a non-partisan, non-profit policy research institute that focuses on the impact on low-income families and individuals of federal and state budgets, programs, and tax policies.

parent and subsidiary corporations. (See the Addendum for an expanded discussion of the theory underlying formula apportionment and combined reporting.)

- With these changes, Minnesota's corporate franchise tax law would still comply with commitments the states made to the federal government when they agreed in the mid-1980s to abandon the "worldwide unitary" approach to corporate income taxation. At that time, states asserted their rights to require companies to include FOCs and tax haven subsidiaries in their water's edge unitary groups. No one suggested at that time that states could not legitimately require corporations to include *all* royalties from foreign subsidiaries in the pool of income subject to normal apportionment rules. (See the Addendum for an expanded discussion of this history.)

- These provisions would not have an adverse impact on the state's economy because most of the corporations benefiting from the tax provisions that would be repealed likely are out-of-state corporations that have created few if any jobs in the state to begin with. Minnesota's corporate franchise tax already highly subsidizes in-state production and research and development by basing tax liability only on in-state sales and by offering a generous R&D tax credit. There is no justification for additional tax breaks that are *not* limited to production and intellectual property development occurring within the state. Moreover, the revenue gained by enacting these provisions would help the state maintain critical investments in an educated workforce and efficient infrastructure, thereby enhancing economic growth and job creation.

The Special Tax Status of Foreign Operating Corporations Should Be Eliminated

Under Minnesota law, foreign operating corporations (FOCs) are corporate subsidiaries formed in the United States that conduct the bulk of their activities abroad. Unlike all other U.S. subsidiaries, they are not included in the water's edge combined group with their U.S. parents and any other U.S. subsidiaries that may be engaged in the same unitary business. Instead, an FOC's entire annual profit is treated as if it were a dividend paid to the parent – regardless of whether any of it is – but 80 percent of this "deemed dividend" is exempt from inclusion in the parent's income subject to normal apportionment rules.

This special treatment of FOCs should be eliminated. They should be treated the same way that all other U.S.-incorporated subsidiaries are, that is, their profits should be included in the apportionable income of the unitary group of which they are a part, and their apportionment factors (property, payroll, and sales in 2013, and sales only beginning in 2014) should be fully included as well. This change should be made for the following reasons:

- **Reducing tax avoidance and evasion**. Excluding *any* unitary corporation from a unitary group opens the door to tax sheltering strategies that involve artificially shifting income into that corporation. Minnesota has already had to engage in several rounds of tightening the definition of FOCs to shut down tax-avoidance strategies that exploited their exclusion, and there simply is no justification for keeping the door open to new strategies that sophisticated corporate attorneys and accountants will try to devise in the future. The fact that ending the FOC exclusion is estimated to generate an additional $18 million in annual revenue provides some evidence that they are still being used as tax shelters in ways that the general public cannot know due to corporate tax return confidentiality and that the revenue department cannot reveal if it does not wish to alert other corporations not yet using these techniques.

- **Other states do not grant special tax status to FOCs**. Several combined reporting states, including California, Massachusetts, and Oregon, do not exclude FOCs from their water's edge unitary groups precisely because they understand how easily they can be used to avoid taxes. Others, such as Illinois, have been forced to take the same kinds of loophole-closing measures that Minnesota has been compelled to do.

- **Consistent with long-standing assertion of state taxing authority**. As far back as the 1983-1984 Worldwide Unitary Taxation Working Group convened by the Reagan Administration, combined reporting states insisted on their right to include FOCs in water's edge unitary groups and presciently explained how the tax-avoidance goals of combined reporting would be undermined if they were excluded.[2]

- **Arguments in opposition by Minnesota corporations ignore beneficial effects of single sales factor formula on their tax liabilities**. Major Minnesota employers assert that they will be harmed by the repeal of the special status of FOCs and that this will be a disincentive to their creating jobs and making investments in the state. Such claims ignore the fact that Minnesota's move toward heavy weighting of sales in the apportionment formula – culminating next year in a sales-only formula – means that these corporations are already paying very little if any corporate franchise tax to the state. That will be true even if FOCs are combined with other members. The major beneficiaries of the current favored status of FOCs are out-of-state corporations with relatively little production but substantial sales in Minnesota. There is no justification for rewarding corporations creating few if any jobs in the state with tax reductions based on exploiting tax sheltering opportunities created by current FOC provisions.

- **Rationale for special treatment of FOCs was flawed from the beginning**. Minnesota excludes from apportionable income 80 percent of the dividends paid to a U.S. parent corporation by a subsidiary formed and doing business in a foreign country. Major U.S. parents headquartered in Minnesota claimed that FOCs ought to be provided a similar exclusion. Otherwise, they, argued, they would do all of their production abroad; better for Minnesota to have a shot at getting a share of the 20 percent of their property and payroll that they were allowed to have in the United States while still retaining FOC status. But accepting these arguments was unwise for numerous reasons:

  - Just because Minnesota chooses to treat a particular subsidiary as an FOC does not mean that the other states in which it is doing business will do the same. The non-combined reporting states in which it is present will tax an apportioned share of its entire income, and some other combined reporting states will combine it with the rest of the water's edge unitary group. Any parent corporation wishing to avoid those consequences can easily do so by incorporating a separate subsidiary abroad to conduct its foreign activity; by itself, Minnesota's decision to grant special tax treatment to FOCs is unlikely to

[2] See: "State Approved Report of the Worldwide Unitary Taxation Working Group," June 1984, pp. 13-14.

dissuade the corporation from doing so. Minnesota's desire to provide roughly-equivalent tax treatment to FOCs and foreign subsidiaries was admirable. However, the adverse consequences for its tax base has outweighed the benefit, particularly in light of the fact that its treatment of FOCs by itself would be highly unlikely to influence a company's decision as to whether to do business abroad via an FOC versus a foreign subsidiary.

- Even if all other states mirrored Minnesota's policy, incorporating a subsidiary abroad would still provide significantly more tax savings than the FOC provision, since dividends remitted to a U.S. parent by a foreign subsidiary do not constitute apportionable income until they are actually paid, while FOC profits are taxed as deemed dividends each year. Any corporation for which the savings would be substantial would make the decision to incorporate abroad, meaning that Minnesota would be forgoing revenue to provide a tax break to companies whose decisions to be incorporated in the U.S. rather than abroad likely would not be affected by it.

- Federal tax considerations magnify these arguments. Given that the federal corporate income tax rate is more than three times that of Minnesota's, and foreign subsidiary income also is subject to federal income taxation only when "repatriated" in the form of dividends, it is federal tax considerations that will drive a corporation's decision as to whether to operate abroad as a foreign vs. U.S.-incorporated entity. It is futile for Minnesota to try to influence that decision with its own tax policy.

In sum, the special tax status of FOCs should be repealed, and they should be included in water's edge unitary groups in the same way that other unitary domestic corporate subsidiaries are. The lack of inclusion has been repeatedly exploited by sophisticated multinational corporations to avoid paying a fair share of tax to Minnesota, major Minnesota employers are not benefitting from the provision to any significant extent because single sales factor apportionment eliminates the vast majority of their tax liability regardless of how much dividend income is included in their apportionable income, and the rationale for the provision was largely a symbolic gesture that would be unlikely to affect corporate behavior.

The Foreign Royalty Exclusion Should Also Be Repealed

Minnesota excludes from the apportionable income of a water's edge combined group 80 percent of the royalties paid to a member of the group by FOCs and by unitary foreign subsidiaries for the right to use patents, trademarks, and other types of intellectual property. This provision should also be repealed. One hundred percent of royalties should be includable in the apportionable income of the unitary group, for the following reasons:

- **Exclusion is inconsistent with fundamental theory underlying income apportionment**. Multinational corporations cannot have it both ways. If they do not want states to mandate *worldwide* combined reporting (WWCR), they cannot selectively exclude categories of income paid from unitary foreign subsidiaries to the U.S. water's edge group. There is no more justification for excluding royalties paid to the U.S. group for the use of intellectual property a member owns than there would be for excluding payment of rent for the use of physical property, like a building or piece of machinery. All of the costs incurred in developing and managing the intellectual property are subtracted as expenses in calculating apportionable income, and all of the receipts from the licensing of the property must be included as well.

- **Royalty exclusion is inconsistent with practices of nearly all other combined reporting states**. Only two of the 23 combined reporting states – Michigan and West Virginia – exclude foreign royalties from apportionable income.[3]

- **"Factor relief" rationale for royalty exclusion is dubious**. One policy rationale often offered for a partial exclusion of royalty income is that it compensates for the fact that states do not provide so-called "factor relief" or "factor representation" for this type of income. That is, while they add all of the royalty payments to the other apportionable income of the water's edge group, they do not add any of the property, payroll, or sales of the foreign (or FOC) subsidiary paying the royalties to the apportionment factors of the group. If the latter were allowed, it would dilute the tax effects of including the royalty income. Here again, the proposal constitutes wanting it both ways. If corporations want the royalty payments to be included and some of the apportionment factors to be included, then *all* of the income of the foreign subsidiary should be included along with *all* of its apportionment factors. *That is, corporations should be required to file on full world-wide combined reporting basis*.

- **"Double taxation" rationale for the exclusion is dubious**. The Reagan Administration's Worldwide Unitary Taxation Working Group discussed the issue of factor relief at some length. The states even offered a compromise proposal in which factor relief would be granted with respect to *dividends* paid by a foreign subsidiary to a U.S. water's edge group.[4] A reasonable argument in favor of factor relief for dividends can be made because dividends are paid out of the profits of foreign subsidiaries, which are themselves subject to tax by their host countries. Factor relief for dividends thus mitigates potential double-taxation of the subsidiary's profit. Royalties paid by the foreign subsidiaries are *expenses*, however, and *reduce* the amount of the subsidiaries' profit subject to home-country taxation. There is no evidence that anyone even suggested that factor relief for royalties was appropriate tax policy during the Working Group's deliberations, let alone that anyone took such an argument seriously.

- **Minnesota corporate tax policy already heavily incentivizes in-state R&D; there is no justification for an additional subsidy**. The principle argument offered in favor of a substantial exclusion of foreign royalties from the apportionable income of a water's edge unitary group is that it provides an incentive for corporations to conduct in Minnesota the research and development that results in the creation of patents, copyrights, and other intellectual property that generates the income.[5] But this argument is misleading. The royalty

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[3] CCH, *2013 Multistate Corporate Tax Guide*, pp. 7011-7015.

[4] See: "State Approved Report of the Worldwide Unitary Taxation Working Group," June 1984, pp. 39-40.

[5] See the undated fact sheet jointly published by the Minnesota High Tech Association and LifeScience Alley, "Research and Development Strengthens Minnesota's Economy." The organizations argue: "The foreign royalty deduction is an important factor in companies keeping R&D operations in Minnesota; it neutralizes incentives to move R&D to foreign locations because it allows companies to compete globally without additional expense attached – keeping key operations

exclusion is available regardless of where in the U.S. the R&D was conducted, regardless of which member of the group receives the royalties, and regardless of whether that member conducts any activity at all in Minnesota. Moreover, Minnesota already heavily subsidizes the conduct of R&D in the state through a generous direct R&D credit and by adopting an apportionment formula that substantially excludes – and will fully exclude next year – all the salaries paid to the people who engage in R&D and all the property they use in their work. If anything, the fact that the royalty exclusion reduces Minnesota tax liability for taxable corporations even if they conduct R&D outside Minnesota *undercuts* the incentives to conduct it in the state provided by single sales factor apportionment and the R&D credit.

Corporations Should Be Required to Include in Their Unitary Groups Subsidiaries Formed in Foreign Tax Havens

Evidence is rapidly accumulating that multinational corporations are managing to shift massive amounts of profits earned in the United States and other host countries to subsidiaries formed in foreign tax haven countries.[6] By limiting itself to water's edge combined reporting, Minnesota has rendered itself substantially defenseless against these practices. Short of adopting full worldwide combined reporting, Minnesota should mitigate the damage to its tax base by requiring corporations to include in their unitary groups subsidiaries formed in readily identifiable foreign tax havens – as proposed in current Senate File 1237/HF 1440.

Three other combined reporting states – Alaska, Montana, and West Virginia – already have such a requirement in their corporate tax laws. As discussed in a March 19 letter to Senators Skoe and Rest and Representative Lenczewski from former Montana Revenue Director Dan Bucks, Montana's requirement has not generated any significant controversy nor engendered any significant compliance problems for corporations. This to be expected, since many multinational corporations do business in states in which they have an option to include *all* foreign subsidiaries in their combined groups, that is, to elect WWCR, and many of them find it advantageous to make such an election.

During the deliberations of the Reagan Administration's Worldwide Unitary Taxation Working Group, it was widely conceded that even if states withdrew from WWCR to water's edge combined reporting, they were fully justified in including tax haven subsidiaries in their water's edge groups. In his final report, Treasury Secretary Donald Regan noted that all five of the alternative water's edge policy "bundles" put forth as potential solutions to the WWCR controversy by state and industry representatives proposed to include in a water's edge group "certain tax haven corporations presumed to be part of the unitary business."[7] It is worth noting that all parties conceded the legitimacy of including in the water's edge group not only subsidiaries incorporated in foreign tax

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in Minnesota. Absent the foreign royalty deduction, these companies would be incented to move some or all of the R&D operations that [sic] invent to the countries where the products are sold."

[6] See, for example, Jane G. Gravelle, "Tax Havens: International Tax Avoidance and Evasion," Congressional Research Service, January 23, 2013.

[7] "Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views," August 1984, p. 30 (item A.5).

haven nations, but even other unitary subsidiaries formed in non tax haven countries doing business in tax havens above threshold amounts. SF 1237 and HF 1440 embody this latter provision.

Tax haven abuse has grown exponentially since the time of the Working Group as more and more corporations have become international in scope and the industry of tax attorneys and accountants specializing in international tax planning has expanded. If the legitimacy of including tax haven subsidiaries in water's edge unitary groups was acknowledged thirty years ago, the justification for such a policy today is even greater. Minnesota should follow the lead of Alaska, Montana, and West Virginia in adopting such a requirement; other states are likely to follow.

Addendum:
The Theory and History of Formula Apportionment and Combined Reporting

The current debate in Minnesota regarding these three corporate income reform tax proposals would benefit from more widespread knowledge of the theory and history underlying how state corporate taxes apply to multistate and multinational corporations.

The Theory of Formula Apportionment

Under Supreme Court interpretations of the U.S. Constitution, states are *prohibited* from taxing corporate profits earned in other states and foreign countries. A state can only legally tax profit that a corporation earns within its borders.

In *calculating* that profit, however, the Court has permitted states to take into account economic activity occurring in other states and nations. The Court has allowed this in recognition of the fact that there is no truly objective way to determine in exactly which taxing jurisdiction the profit of a corporation doing business in multiple jurisdictions is earned. That is particularly true where some of the corporation's profit is clearly attributable to economies of scale or other forms of economic synergy that flow from the worldwide scope of operations. Thus, for example, if a company's R&D lab in California develops a drug that is sold directly to consumers in Minnesota but also generates "foreign" royalty income when the company licenses the right to produce the drug to a German subsidiary, Minnesota is allowed to take that royalty income into account in figuring out how much of the company's worldwide income it can tax. The reason is that there is no objective way to assign the up-front development costs of that drug to the Minnesota sales as opposed to the foreign ones. Moreover, if Minnesota could not take the foreign royalties into account and the foreign sales were in a low-tax country, the company would have an enormous incentive to assign virtually all of the development costs to the Minnesota sales – minimizing taxable profits reported to the state and maximizing the profits reported to the foreign country.

States implement this court-granted authority to take out-of-state activities into account in by first requiring corporations to first calculate their worldwide profits by taking their worldwide revenues and subtracting their worldwide expenses.[8] The states then determine the *share* of that worldwide income that is earned within their borders, and which they therefore have the right to tax, by applying an "apportionment formula" to that income. The U.S. Supreme Court approved formula apportionment of corporate profits in a 1920 decision and its application to foreign corporations in 1924.[9] The major condition that the Supreme Court has placed on the states' authority to take out-of-state activities of a corporation into account in determining its income tax liability is that those activities have to be part of the same basic business that the corporation is

[8] Corporations must first conduct sufficient activity within a state to cross a threshold of taxability, or "nexus."

[9] *Underwood Typewriter Co.* v. *Connecticut* (1920); *Bass, Ratcliff & Gretton, Ltd.* v. *New York* (1924).

conducting in the taxing state. In common parlance, the in-state and out-of-state activities have to be part of a "unitary business."[10]

In most states with corporate income taxes, apportionment formulas originally were based on the locations of a corporation's property payroll, and sales. Under the original formula, if a corporation had 20 percent of its worldwide property, 10 percent of its worldwide payroll, and 30 percent of its worldwide sales in Minnesota, Minnesota would have taxed 20 percent of its worldwide profit; the average of 20 percent, 10 percent, and 30 percent is 20 percent. (As discussed in the body of this statement, Minnesota will apportion worldwide profit to itself solely on the basis of a corporation's sales beginning next year; it has been moving toward that formula for more than decade.)

Combined Reporting

As originally implemented in most states, apportionment formulas were applied individually to each individual corporation in a multi-corporation group composed of a parent and subsidiaries. Not long after the Supreme Court approved formula apportionment, however, some states came to realize that its two fundamental objectives – assigning the profits of a multi-jurisdictional corporation for tax purposes to specific jurisdictions in reasonable relationship to the locations of the corporation's underlying economic activities, and preventing deliberate manipulation of those assignments – could easily be undermined if states recognized for tax purposes how corporations divided themselves internally. Accordingly, several states began implementing "unitary combined reporting" (usually shortened to "combined reporting"). They required corporations composed of a parent and subsidiaries engaged in a unitary business to first add-together their profits, and then to apply the state apportionment formula to that combined income. Under such a practice, transactions between the related companies are effectively eliminated – one corporation's receipts are the other corporation's expenses, and the latter is subtracted from the former to determine profit. Only transactions conducted with parties *outside* the unitary group contribute to the group's measured profit. As with formula apportionment itself, combined reporting is not some kind of back-door effort to tax the income of the out-of-state parent or subsidiary; the goal is to calculate the portion of the multi-state, multi-entity corporation's worldwide income that can reasonably be attributed to the taxing state.

By the time Minnesota enacted legislation to mandate combined reporting in 1982, roughly a dozen states had already done so.[11] Approximately two-thirds of them mandated "world-wide combined reporting" (WWCR). That is, they required the corporations they had authority to tax to include in their unitary combined groups not only parents and subsidiaries formed in the U.S., but also those formed in foreign countries.

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[10] A "vertically-integrated" corporation drilling for oil in Texas and refining the extracted oil in Louisiana would very likely be considered a unitary business. A "horizontally-integrated" corporation with retail stores in Pennsylvania and Maryland and a warehouse in West Virginia would also likely be considered a unitary business. A corporation that owned a cattle ranch in Oklahoma and a taxi company in Kansas would likely be considered to be operating two distinct unitary businesses.

[11] Today, 23 states and the District of Columbia mandate combined reporting.

The Reagan-Era Worldwide Unitary Taxation Working Group

By the late 1970s mandatory WWCR had generated a furor, particularly driven by multinational corporations headquartered abroad who maintained that it violated tax treaties between their home countries and the U.S. The controversy had also generated constitutional challenges to WWCR from U.S.-based multinational corporations that were on their way to the U.S. Supreme Court. Given this controversy, when Minnesota enacted combined reporting in 1982 it decided to only require inclusion in Minnesota unitary groups of U.S. parent corporations and subsidiaries legally formed in the U.S – so-called "water's edge" combined reporting. It is worth noting, however, that Minnesota *did* require inclusion in the unitary group of corporations that would now be termed FOCs – subsidiary corporations formed in the U.S. but with most of their activity abroad.

The U.S. Supreme Court upheld the right of states to require U.S. corporations to calculate their state income taxes using worldwide combined reporting in 1983.[12] Corporations almost immediately turned to the Reagan Administration for relief, asking it to support federal legislation banning the practice, which had been introduced in Congress for many years but never enacted. Instead, the Administration organized a federal/state/industry "Worldwide Unitary Taxation Working Group" to see if a compromise could be forged. It met from late 1983 to mid-1984. In addition to combined reporting, it addressed alternative means by which states might take non-U.S. operations of multinational corporations into account in calculating state corporate income tax liability.

The Working Group was unable to reach an agreement on the full range of issues it addressed. However, in recognition of the fact that they were at substantial risk of seeing federal legislation enacted banning WWCR entirely, the combined reporting states agreed that they would abandon mandatory WWCR and withdraw to a "water's edge" variant instead. That is, they would allow corporations to calculate their income tax liabilities by including in the combined group only parent and subsidiary corporations formed in the United States, not those formed in foreign countries.

This concession was predicated on three conditions, however:

- That states could continue to include in their water's edge unitary groups corporate subsidiaries formed in the U.S. that did most of their business abroad, that is, what Minnesota now labels "foreign operating corporations;"
- That states would continue to have the right to include dividends paid by foreign subsidiaries to their U.S. parents in the apportionable income of the water's edge group; and
- That the Internal Revenue Service would take a number of administrative steps to reduce the ability of corporations to artificially shift income abroad, to help preserve the revenues of both states and the federal government.[13]

Two additional aspects of the Working Group discussions that bear on the current debate in Minnesota should be noted:

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[12] *Container Corporation* v. *California Franchise Tax Board*, June 27, 1983. The Court would uphold the application of WWCR to *foreign*-parent corporations in 1994 in the case of *Barclays Bank* v. *California Franchise Tax Board.*

[13] See: "State Approved Report of the Worldwide Unitary Taxation Working Group," June 1984, pp. 26-41.

- Although corporate representatives on the Working Group vigorously pressed their position that states should not have the right to include in apportionable income dividends paid to U.S. parents by their foreign subsidiaries, there is no indication in the Working Group final report that they took the same position with respect to royalties; and

- Even the industry members of the Working Group conceded that states should be allowed to include in a water's edge combined group certain corporations formed or doing business in foreign nations identifiable as low-rate tax havens.[14]

In the years following the Working Group's activities, every WWCR state changed its laws either to require water's edge combined reporting or to allow corporations to choose between water's edge and WWCR.[15] Notwithstanding their insistence during the Working Group deliberations on preserving their right to include FOCs in their water's edge groups and to include dividends received from foreign subsidiaries in apportionable income, a number of states subsequently either excluded both entirely or exempted a portion of these types of income. Minnesota, of course, was among the states that enacted such exemptions. In 1988 Minnesota enacted legislation allowing corporations to deduct from apportionable income 80 percent of the royalties received from a foreign subsidiary or an FOC. The legislation also treated the annual profit realized by an FOC as a dividend that was deemed to have been paid to the parent corporation – whether or not it actually was – but allowed the parent to deduct 80 percent of the deemed-dividend from apportionable income.

Conclusion

Here are the key points to be taken away from this history of the theory and practice of formula apportionment and combined reporting that are relevant to the current debate in Minnesota:

- Almost 100 years ago, the states developed and the courts sanctioned formula apportionment as a fair and rational means of measuring the amount of income multistate and multinational corporations earn in a state.

- As far back as 1924, the Supreme Court allowed states to take foreign receipts into account in applying formula apportionment. Although that case involved a corporation based abroad and selling physical merchandise abroad, the principles enunciated completely support including in a U.S. corporation's apportionable income all the royalties paid to it by foreign licensees of its intellectual property.

- Combined reporting is a logical extension of formula apportionment, and the courts have sanctioned it as such. If combined reporting is not required, corporations can easily shift income that is actually earned within their borders beyond the reach of their income taxes by engaging in artificial transactions – or real transactions at artificial prices – with commonly-

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[14] See: "Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views," August 1984, p. 30 (item A.5) and p. 51 (footnote 2).

[15] The only exception to this is that Alaska requires multinational oil companies to file on a WWCR basis.

owned but legally-separate out-of-state corporations that states do not have the legal authority to tax.[16] Minnesota enacted combined reporting in 1982 in recognition of this fact.

- These same income-shifting techniques can and are used internationally, and that is why by 1980 many combined reporting states mandated worldwide combined reporting. The Supreme Court blessed that policy as applied to U.S. and foreign-headquartered multinational companies in 1983 and 1994.

- Even as they agreed under pressure from the federal government in the early and mid-1980s to require or allow corporations to calculate their tax liabilities using water's edge rather than worldwide combined reporting, combined reporting states vigorously asserted their rights to include in their water's edge groups U.S. subsidiaries with the bulk of their operations abroad and subsidiaries formed or doing business in tax haven countries. Even the corporate community effectively acknowledged the legitimacy of the latter choice.

- There is no evidence that at the time this debate was going on, any member of the business community suggested that it was incorrect policy for water's edge combined reporting states to include in apportionable income all royalties paid to U.S. parent corporations by their foreign subsidiaries.

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[16] Income-shifting techniques that exploit the absence of combined reporting are discussed at length in Michael Mazerov, "State Corporate Tax Shelters and the Need for Combined Reporting," Center on Budget and Policy Priorities, October 2007. The focus of the paper is on tax shelters that shift the income from state to state, but many of the techniques can and are used to shift income from the United States to other countries.