HOW THE STATES CAN TAX SHIFTED CORPORATE PROFITS:
AN APPLICATION OF STRATEGIC CONFORMITY

DARIEN SHANSKE*

The combination of pandemic, recession and federal dysfunction has put severe fiscal strain on the states. Given the scale of the crisis and the essential nature of the services now being cut, it would be reasonable for states to contemplate inefficient—and even regressive—revenue-raising measures. Yet surely they should not start with such measures. They should start with making the efficient and progressive improvements to their revenue systems that they should have made anyway.

Improving the taxation of the profits of multinational corporations—the topic of this Article—represents a reform that would be efficient, progressive, and relatively straightforward to administer. Not only would such a reform thus represent good tax policy, but it would also raise significant revenue. And, if substantial revenue, efficiency, progressivity and administrability are not sufficiently motivating, then I will also add that it would be particularly appropriate to make these changes during the pandemic so as to raise revenue from those best able to pay during the current crisis.

To be sure, the argument that states can and should tax multinational corporations more has the whiff of paradox. After all, there is general

* Professor, UC Davis School of Law. Many thanks to audiences at the Association of Mid-Career Tax Professors, the NorCal Tax Roundtable, the University of Minnesota Law School Perspective on Taxation Lecture Series and to Eric Allen, Revuen Avi-Yonah, Kimberly Clausing, Steven Dean, Peter Enrich, Michael Fatale, David Gamage, Mark Gergen, Kristen Hickman, Ken Levinson, Michael Mazerov, Amy Monahan, Susie Morse, Michael Simkovic and Adam Thimmesch. I am particularly grateful to David Gamage who coauthored some shorter pieces on which this Article is based. All opinions and mistakes are my own.
consensus that no nation-state is currently taxing multinational corporations very effectively and, further, that subnational governments are in an even worse position to do so. This is because multinational corporations can exploit the mobility of capital even more easily between parts of the same country. Nevertheless, I will argue that the American states find themselves in a particularly strong position to do better at taxing multinational corporations and this is in part precisely because of the missteps made at the federal level.

The Tax Cuts and Jobs Act ("TCJA"), passed in December 2017, contained several provisions, including rules concerning Global Intangible Low-Taxed Income (or "GILTI"), that were meant to combat income stripping. The GILTI provision identifies foreign income likely to have been shifted out of the United States and subjects it to U.S. tax.

In this Article, I argue that the states should and can tax GILTI income. The basic policy argument is simple: states should not miss a chance to protect their corporate tax bases. The amount of revenue at stake is not trivial; it could be as high as $15 billion per year for the states as a whole or the equivalent of a 30% boost in corporate tax collections.

The basic legal argument is also simple: it cannot be the case—and it is not the case—that states need to take corporations at their word as to where their income is earned. If the states can make a reasonable argument that nominally foreign income has in fact been shifted out of the United States, then their choices as to their tax system should be respected.

This Article makes several other core arguments. First, the Article argues that returning to mandatory worldwide combination as a complete alternative to GILTI conformity would be preferable to GILTI conformity alone. Second, the Article argues that offering taxpayers a choice between GILTI conformity and worldwide combination is preferable to GILTI conformity alone.

Finally, this Article places all these issues in a larger framework of strategic conformity. As with GILTI, the states should look for other opportunities where they can take advantage of federal miscues while also advancing sound tax policy.
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INTRODUCTION

This paper was substantially complete before the COVID-19 pandemic and associated recession. These events, along with the federal government’s failure to respond adequately to them, have put severe fiscal strain on the states. Given the scale of the crisis and the essential nature of the services now being cut, it would be reasonable for states to contemplate inefficient—and even regressive—revenue-raising measures. Yet surely they should not start with such measures. They should start with making the efficient and progressive improvements to their revenue systems that they should have made anyway.

Improving the taxation of the profits of multinational corporations—the topic of this Article—represents a reform that would be efficient, progressive and relatively straightforward to administer. Not only would such a reform thus represent good tax policy, but it would also raise significant revenue. And, if substantial revenue, efficiency, progressivity and administrability are not sufficiently motivating, then I will also add that it would be particularly appropriate to make these changes during the pandemic so as to raise revenue from those best able to pay during the current crisis.

To be sure, the argument that states can and should tax multinational corporations (“MNCs”) more has the whiff of paradox. After all, there is general consensus that no nation-state is currently taxing MNCs very effectively and, further, that subnational governments are in an even worse position to do so. This is because MNCs can exploit the mobility of capital even more easily between parts of the same country. Nevertheless, I will argue that the American states find themselves in a particularly strong position to do better at taxing MNCs and this is in part precisely because of the missteps made at the federal level. I will briefly explain.

The federal tax law passed in December 2017, known as the Tax Cuts and Jobs Act (“TCJA”), includes a number of new antiabuse rules meant to combat income stripping. Income stripping occurs when a profitable corporation engages in tax planning techniques (more on these shortly) so

that profits that are taxed in a relatively high-tax jurisdiction, like the United States, are formally earned in a low or no-tax jurisdiction. One important new antiabuse rule is called the Global Intangible Low-Taxed Income (or “GILTI”) regime. The essence of how the GILTI rules work is by identifying foreign assets that are unusually profitable by means of a formula and then subjecting those excess profits to U.S. tax on the theory that they were not really earned abroad, but shifted out of the United States.

The size of the income shifting problem is in dispute, but there is broad consensus that it is a large problem and one that is not going to be much improved by the new federal laws meant to combat it. Current respected estimates of the amount of income shifted out of the United States to low-tax jurisdictions are about $300 billion per year, with the federal government projected to lose about $100 billion per year. The Penn Wharton Budget Model has found that the amount of income available to be taxed by the states if they tax GILTI to be in the same range (about $200 billion in 2020). Based on that $200 billion estimate, states could raise $15 billion in new revenue if they applied a 7% rate (about the current average). This would represent about a 30% increase in state corporate revenue.

That is a lot of money. It is also important to keep in mind that states could borrow against a new revenue stream like GILTI in order to help pay for the immediate crisis.

4. Jane G. Gravelle, Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?, N.Y.U. COLLOQUIUM ON TAX POL’Y & PUB. FIN. 1 (Apr. 26, 2016), http://www.law.nyu.edu/sites/default/files/upload_documents/Jane%20Gravelle.pdf [https://perma.cc/WHA5-KHZQ] (“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.”).


9. See Darien Shanske & David Gamage, The Case for State Borrowing as a Response to the
For the over forty states with a corporate income tax, the real question is why would they not raise this revenue from mobile capital and protect their tax base. Of course, representatives of MNCs have argued over and over that they should not and indeed that states cannot conform to GILTI. To date, these representatives have been successful in convincing almost all the states—even blue states, even blue states that could have really used the revenue before the current crises (I am looking at you, Illinois). Yet note that in many cases, states have not acted one way or the other and that states are still considering the issue. Even states that have affirmatively chosen not to tax GILTI can change their minds in light of recent events.

Accordingly, I will argue at length in this Article (and have argued briefly elsewhere), that the states should and could conform to GILTI. Or, to be more precise, the states should strategically conform because, as we will see, the states should not conform to every aspect of GILTI as applied at the federal level.

Strategic conformity means that the state should conform in ways that make the state versions of the law more effective at combating income stripping than the federal law on which it is based. Though I cannot prove it, I suspect that the ferocity with which the industry has fought state conformity to GILTI is related to a similar assessment about the possible effectiveness of state GILTI regimes as compared to the federal regime.

The argument of this Article also has a back-to-the-future component.

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11. Amy Hamilton, TCJA State Tax Lobbying in 2019, and What’s Up Next in 2020, 94 TAX NOTES ST. 949, 949 (2019) (“Persuading so many states to decouple from global intangible low-taxed income has got to be one of the biggest state tax lobbying success stories of 2019, though no corporate tax lawyer put it that bluntly.”).


The states, and California in particular, pioneered an approach to the taxation of MNCs that was widely perceived as effective, so much so that the federal government was considering copying the state approach. This approach, called mandatory worldwide combination, was challenged by MNCs, but was upheld by the Supreme Court—twice. And then a funny thing happened. Foreign MNCs, particularly in the United Kingdom and Japan, pressured their governments, who in turn pressured the federal government and who in turn pressured the states. The threat was that states needed to retreat from mandatory worldwide combination or face preemption by the federal government. The states retreated.

Federal tax policy has further encouraged erosion of state corporate tax bases in other ways, including: (1) the check the box regulations, which undermined Subpart F (a Kennedy era attempt to curb income stripping); and (2) providing and proposing repatriation holidays, which have further encouraged income shifting. (If the shifted income will eventually receive the benefit of a repatriation holiday, then why not shift more of it now?) Thus, the federal government has forced the states to abandon their best tool to counter profit shifting while simultaneously acting in ways that have served to exacerbate the profit shifting problem.

And now we have GILTI. A central component of the TCJA was shifting the federal corporate tax base from being based on the worldwide income of U.S. corporate taxpayers to a territorial system whereby the


17. Hellerstein, supra note 15. It is an interesting question, especially in light of the Court’s subsequent federalist turn, whether such a broad preemption of state taxing power would even be permissible. For further discussion of the issue, see Shanske, Respond Strategically, supra note 14, at 546.


foreign income of U.S. corporate taxpayers is potentially exempt from tax. The switch to a territorial system for the U.S. corporate tax base turbocharges the already ample incentives taxpayers have to engage in profit-shifting tax avoidance transactions.

GILTI is a serious, if flawed, attempt by the federal government to counter a problem that otherwise federal tax policy was going to make dramatically worse. In other words, over thirty years after claiming the intention to help state governments counter profit shifting in order to make up for the loss of worldwide combination,21 the federal government has finally—if not exactly deliberately—made good on this commitment by offering states a new tool to combat income shifting. They should take it and improve it.

Better still, the states should consider going back to mandatory worldwide combination. Given the intense interest of other advanced economies (the OECD) in the income shifting problem and the fact that the federal government is itself taking the issue seriously, now is an opportune moment to boldly use a piece of 1980s tax technology that has not yet been improved upon.

The argument of this Article will proceed along two main tracks. The first track will be to make the case, as a matter of theory, for states to try harder to tax the income of MNCs. The traditional view is that states should not be trying to tax this type of income.22 The second track, and in many ways the more important one, is the practical track. It is perhaps not too surprising to suppose that, at the level of theory, I could conjure up a series of conditions under which it would make sense for states to pursue mobile capital, but that does not matter if the conditions do not obtain. Yet, as I will argue, the conditions do obtain. A slew of developments, including the passage of the new federal tax law, international initiatives regarding base erosion, and many others, all indicate that the states have an extraordinary opportunity.


I. BACKGROUND ON THE STATE CORPORATE INCOME TAX

Forty-four states (and Washington DC) levy a Corporate Income Tax (“CIT”), and it raises substantial revenue (about $54 billion in 2016), though not a large percentage of state revenue (about 3.4% of state taxes or 2.3% of all own sourced revenues).

State CITs, like state personal income taxes, are generally modeled on the federal tax system. Thus, a typical state CIT looks to see how much income a corporation has at the federal level and then requires or allows certain state-level adjustments. States may require that a corporation report more income by denying a federal credit or deduction and often allow corporations to report less income by making additional state level credits available.

There are two main legal differences between the federal and state CIT calculations. First, a state cannot tax just any corporation, just like a state cannot tax just any person. The Due Process Clause and the dormant Commerce Clause require an appropriate level of connection—nexus—between the state and corporation. Second, even if a state has nexus with a corporation, it cannot tax all of that corporation’s income. And so, for example, California cannot tax all of Apple’s income, just the income that can be reasonably attributed—apportioned—to California.

For many decades, the states have used a multifactor formula to establish what part of a multistate corporation’s business income may be apportioned to a given state. The traditional formula used three equally weighted factors or ratios: property, payroll, and sales. The intuition behind this formula was that a corporation benefited from owning property in a state, from having customers in a state and from having employees in a state, and so these were appropriate factors.

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26. These differences are not absolute, as, within the international system, the United States as a single nation-state has to demonstrate an appropriate relationship to the entity and income being taxed.
27. A further limitation is that the business income being taxed by the state is part of a unitary business with the business actually being conducted in the state. Acceptance of this principle, the “unitary business principle,” dates to nineteenth-century cases addressing the taxation of railroads. See, e.g., Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 229 (1897); State R.R. Tax Cases, 92 U.S. 575, 576 (1875); The Del. R.R. Tax, 85 U.S. 206, 231–32 (1873). If Apple were to purchase a sheep farm in another state, then California could not combine the income from that farm with the income of the technology corporation unless the farm were part of the same business.
For example, suppose California has the traditional three-factor formula and Apple, a corporation with which California has nexus, has $1 billion in profits. Suppose Apple owns 20% of its total property in California, has 30% of its employees in California, and makes 10% of its sales in California. Since each factor is weighted equally, the blended ratio \(((10\% + 20\% + 30\%) / 3)\) is 20%, meaning that Apple is taxable on $200 million in profits in California. Remember, this is not what Apple owes, just what California can tax. If California has a 10% CIT rate, then Apple owes $20 million.

For the last three decades, there has been a trend to emphasize the sales factor (for example, to weigh it doubly)—or to use only the sales factor.\(^{28}\) So, in the above example, California would only tax Apple on 10% of its income because that is the proportion of sales within the state.

A. CURRENT STATE TAX POLICY MOMENT

State legislators, like most people, apparently do not like thinking about taxes. After all, the basic architecture of most state taxes is at least ninety years old. It could be, of course, that this inertia is a result of the old regime actually doing a good job, but this would seem to be an exceedingly Panglossian view. Not only is there very considerable evidence of widespread and long-term state and local under-investment in public goods, like infrastructure,\(^{29}\) but also the states predictably face fiscal crises during recessions. Even worse, there is broad consensus that states and localities face increasing fiscal pressure as a result of previous overpromising and underinvesting in connection with their pensions systems.\(^{30}\)

It is therefore always a good time for states to be thinking about tax reform—even though they rarely do. Yet the current moment is an especially auspicious moment for states to consider their revenue systems. In the midst of the current pandemic and recession, the states find themselves in the pincer grip of having increased needs and reduced revenues.\(^{31}\) Even worse,


\(^{30}\) See, e.g., D. Roderick Kiewiet & Mathew D. McCubbins, *State and Local Government Finance: The New Fiscal Ice Age*, 17 Ann. Rev. Pol. Sci. 105, 106–107 (2014) (“What we are experiencing is the onset of the New Fiscal Ice Age, a period in which a given level of state and local tax revenue purchases a considerably lower level of current services. The fiscal climate confronting state and local governments will not improve during the lifetime of anyone reading this article.”).

\(^{31}\) See supra note 4.
the ineffectual federal response to this national emergency has increased the need for state and local spending on pandemic response and unnecessarily further suppressed the economy while, as of this writing, failing to provide substantial support to state and local governments. Much of the current state and local tax infrastructure was put into place during the Great Depression. The current crises, including of federal competence, have placed similar unprecedented burdens on the states and should trigger a similar rethinking.

Yet even before the current crises, the advent of the TCJA in December 2017 offered at least two more broad reasons to do so now. First, as will be discussed in some detail below, this new tax law makes major changes to the U.S. tax system and the states with income taxes have to respond to those changes, even through nonresponding. Second, one particular change made by the TCJA, the repeal of the state and local tax (“SALT”) deduction, puts particular pressure on states with progressive income taxes.

This Article argues that changes made by the TCJA provide an opportunity for states to reform their corporate income taxes in ways that will raise more revenue in a relatively progressive manner, with relatively little economic distortion and with relatively little administrative burden.

It is very unusual for a policy to advance fairness and efficiency, while being administrable (the holy trinity of tax policy). For instance, it would be administrable, and maybe efficient, to raise revenue by increasing the payroll tax, but this would definitely not advance fairness according to the ability to pay principle. A wealth tax would be progressive, but the efficiency and administrability of such a tax is fiercely debated.

Some qualifications and context are in order. First, the argument of this Article for expansion of state corporate taxation is not meant to suggest that states would not do better if they improved their systems for taxing consumption and property first of all. I have argued at length in favor of improving these much larger (and flawed) bases and still think that this is...
where state and local tax reform should begin.

To further illustrate the revenue potential of corporate tax reform with some numbers, note that the state corporate income tax in California is producing about $11 billion per year, about 8.5% of a state budget of about $130 billion (and leaving aside the local altogether).35 One reasonable estimate for how much California could gain if it prevented all corporate income shifting is $2.8 billion36 or an increase of about 25% of CIT. And remember, California would raise this revenue at relatively low administrative cost. This is real money in a time of need, especially if paired with other reforms or borrowed against.

Leaving aside new initiatives, states need the CIT base not to wither away; state corporate tax reform is actually necessary to maintain the status quo.37 The CIT has been in decline at the state and federal level for decades.38 The reasons for the decline are many, including: there is more tax avoidance and planning on the part of corporations; there has been an increase in state expenditures through the corporate income tax aimed (implausibly) at economic development; and there has been an increase in new legal entities, particularly LLCs, that are attractive alternatives to corporations.39

The state-level corporate tax has been in decline even more than the federal corporate tax. In particular, the productivity of the tax has declined relative to the increased profitability of corporations. For a graphic representation of this point, see this chart put together by the Center on Budget and Policy Priorities:

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143, 144–45 (2014).
t.ca.gov/2019-20/pdf/BudgetSummary/FullBudgetSummary.pdf [https://perma.cc/AD3V-WCAA].
36. RICHARD PHILLIPS, INST. ON TAX’N & ECON. POLICY (ITEP), NATHAN PROCTOR, U.S. PIRG
EDUC. FUND, SALESFACTOR.ORG & AM. SUSTAINABLE BUS. COUNCIL (ASBC), A SIMPLE FIX FOR A $17
BILLION LOOPHOLE: HOW STATES CAN RECLAIM REVENUE LOST TO TAX HAVENS 1, 17 (2019),
https://itep.org/wp-content/uploads/A_Simple_Fix_for_a_17_Billion_Loophole_USPIRG_IE_%ITEP.pdf
[https://perma.cc/CG2C-ALJT]. The ITEP report takes a conservative estimate of income shifting in total and then apportions the loss by state and thus this estimate is based on complete success vis-à-vis combating income shifting.
37. As a matter of retail politics, it is hard to imagine a revamped consumption tax being paired
with an elimination of the corporate income tax, for example.
38. STEVEN MAGUIRE, CONG. RSC. SERV., RL32297, STATE CORPORATE INCOME TAXES: A
DESCRIPTION AND ANALYSIS 8 (2008).
39. See, e.g., BRUNORI, supra note 25, at 100–03; Chad H. Hill, Corporate Income Tax Reform:
The View from the States, 61 ST. TAX NOTES 853, 853 (2011); William F. Fox & LeAnn Luna, Do Limited
Liability Companies Explain Declining State Corporate Tax Revenues?, 33 PUB. FIN. REV. 690, 690
(2005). Note that states are making it more difficult to escape the CIT through use of LLCs, though not
uniformly. See Fox & Luna, supra, at 715 (noting trend).
II. THEORETICAL CONSIDERATIONS

With this background in place, we have a sense of why states might want to pursue corporate tax reform, but could they succeed? Traditional theory, and some evidence, suggests not. I will argue that matters are not what they seem, at least at the moment.


41. It is too early to conclude much about this data point, but it is worth noting that New Jersey, which is the state that has gone farthest in pursuing corporate income post-TCJA (including GILTI conformity, but also taxing the repatriation), has seen its CIT collections increase 144%. Treasury: March Revenue Collections Rise 16.9%, Income Tax Up 22.9%, N.J. DEP’T TREASURY (Apr. 11, 2019), https://www.nj.gov/treasury/news/2019/04112019a.shtml [https://perma.cc/SJJ4-YP2C].
A. TRADITIONAL ARGUMENTS AGAINST THE STATE CORPORATE INCOME TAX

The theory of tax assignment assigns to states taxes that are imposed on relatively immobile tax bases, and in particular on property and consumption. The problem with states taxing a more mobile base, like corporate income, is that it will slip away. The relative decline of the state corporate base seems to be proof that theory is being borne out. Indeed, many recent changes to the state corporate income tax, such as the shift to the single sales factor, are concrete manifestations of states responding to this pressure on this tax base. This is because a shift to the sales factor is a shift to a less mobile factor (that is, the location of sales), but, at the same time, a more malleable one, and hence, so far, the shift to the sales factor has lost states revenue.

It might not be a big deal to continue taxing a declining base if it were easy to do, but the second big critique of the state corporate income tax is that it is not easy to do. States do broadly piggyback on the federal corporate income tax, but that does not make the tax easy to administer. Not only is there the issue of the various state-level deviations as to the tax base, but, more systematically, states, as a matter of constitutional law, must divide up the income of multistate corporations by means of a formula. Applying these formulas—and strategizing about them—takes considerable time and effort.

B. SURPRISING ARGUMENTS FOR THE STATE CORPORATE INCOME TAX

Despite the strong arguments against the tax, there are, I believe—and for the moment at least—stronger arguments to retain and supplement it. To preview, and put the argument very roughly, this Article does not challenge the basic theory that smaller jurisdictions—more vulnerable to the exit of wealthy taxpayers and capital—ought to focus on taxing relatively immobile tax bases. Rather, my argument is that, under the right circumstances, the argument for taxing corporate income can be particularly compelling in spite of the broad truth about subnational jurisdictions and mobility. I offer five reasons for states to retain and reform the corporate income tax below.

First, there is a strong case that a growing percentage of corporate profits represents excess returns rather than normal profits. This is

43. Shankse, Fiscal Capacity, supra note 34, at 487–89 (discussing literature).
44. Laura Power & Austin Frelick, Have Excess Returns to Corporations Been Increasing Over Time?, 69 NAT’L TAX J. 831, 841 (2016); Fox, supra note 33, at 78–79.
particularly true for corporations that have a large amount of intangible assets.\textsuperscript{45}

To understand what an excess return is, one must first turn to normal returns. A normal return should compensate an investor for the level of risk that she has taken on; a supranormal or excess return or economic rent is compensation beyond what would be required to make a certain investment given a certain amount of risk.\textsuperscript{46}

To flesh out the point here, consider a thumbnail sketch of the market for pizza as contrasted to the market for smart phones. No one is going to sell pizza if they do not make a reasonable return on their investment. However, if a particular pizzeria is making an extremely high return because of its location or style of pizza, then it can expect some other pizzeria to come to the neighborhood and/or copy its style so that the first pizzeria has its returns reduced. Now consider iPhones. Naturally, Apple needs to make a profit and, given the upfront costs it incurs in developing the phones, a higher profit margin than a pizzeria. Yet Apple is probably making much more than enough to compensate it for its greater risk. To see this, consider how hard it would be for a competitor to drive down Apple’s prices. After all, because of Apple’s ownership of its intellectual property, a competitor’s phone cannot be too similar. On top of that, Apple benefits from its brand and the network effect of having millions of phones already out in the market.

What is the significance of excess returns to tax? The significance is that, all else equal, if an activity is producing a supranormal return, then a taxpayer will not do less of it if it is taxed so long as the tax is not so high that the taxpayer does not even retain normal returns.\textsuperscript{47} Suppose the normal return for a given level of risk is 8%. If taxes on one particular activity reduces the return to 7%, then taxpayers will abandon this activity for those that still yield 8%. Suppose instead that the normal return is 8% and a taxpayer is earning 25% and then suppose that taxes reduce this return to 16%. The taxpayer will continue doing the 16% activity because it is very unlikely that she will find another investment that will yield twice the normal return for a given level of risk. The upshot is that it is therefore efficient for states to try to tax the corporate tax base to the extent that corporate returns increasingly represent excess returns.\textsuperscript{48}

\textsuperscript{45} Power & Frerick, supra note 44, at 837.
\textsuperscript{47} Id. at 202.
\textsuperscript{48} If the tax base were changed, and in particular, full expensing were permitted, then the
Second, there is an efficiency argument for taxing federal tax bases in strategic ways.\textsuperscript{49} This argument requires a few steps. First, a fundamental tenet of tax economics is that the amount of deadweight loss generated by a tax increases at the square of the tax rate. The jargon is convoluted, but the behavioral intuition is simple. Consider how much trouble you would go to avoid a 5% tax. Now imagine how much more trouble you would go to avoid a 20% tax. You might not do anything to avoid a 5% tax, but you would do a lot to avoid the 20% tax—hence the exponential growth in wasteful tax planning and lost government revenue.\textsuperscript{50}

Note that this first point can be put a different way: all else equal, it is more efficient to raise revenue by broadening the base of a tax relative to raising the rate of a tax. Pulling GILTI back into a state tax base is a more efficient way of raising revenue relative to raising the corporate tax rate. But there is another way that GILTI conformity can be efficient, which brings us to analytic step number two.

The second step requires making the observation that different taxes can be evaded in different ways. I can avoid paying income tax by deferring the sale of appreciated assets, but this does not help me avoid paying sales tax on my new car. I used to be able evade the sales tax by purchasing from a remote vendor online, but this never helped with the income tax. The fact that different taxes can be evaded along different margins has the following implications in the federal system as currently in operation: when the states try to collect more revenue by piggybacking on the federal income tax, they are essentially increasing an already high tax rate and spurring additional evasion. By contrast, when states raise revenue with the sales tax then they are raising money using relatively low tax rates that do not cause as much evasion.

Of course, I have not yet demonstrated how state corporate income taxes might take advantage of this insight. Again, typically state corporate income taxes do piggyback on federal taxes.\textsuperscript{51} But, assuming that there is a corporate income tax would be more directed at excess returns.


\textsuperscript{50} To be precise, when a tax is imposed, say on gasoline, both the producers and consumers lose out on otherwise efficient transactions in an amount greater than the revenue the government raises by imposing the tax. \textit{See Jonathan Gruber}, \textit{Public Finance and Public Policy} 591 (4th ed. 2013).

\textsuperscript{51} If the federal government were to move to a much different type of tax on mobile capital—say a securities tax—then the possible benefit to the states of retaining a corporation income tax is even stronger, at least so much as the margin argument is concerned. It could well be, of course, that the
way for the states to tax corporate income along a different margin (at least somewhat), then this is another efficiency argument in favor of state corporate income taxes, suitably designed.

Another complication is the empirical question whether current state corporate income tax rates are low enough not to spur significant evasion on their own, and this is a fair question. Though state corporate tax rates are very likely high enough to spur some evasion, there is evidence that this effect is relatively muted.52 Thus, all else equal, states can efficiently tax corporate income so long as their rates remain at about current levels.

There is a third reason, somewhat perverse, for states not to relinquish the state corporate income tax. Suppose that state corporate income taxes do still result in significant—and costly—evasion because corporations respond to the combined state and federal rate. If this is so, then, as David Gamage and I have demonstrated in an earlier paper,53 the costs fall more on the federal government than on the states because the rate of the federal tax is higher. Here is a simple example. Taking a god’s eye view, suppose a corporation has $1,000,000 in net income. Suppose as well that the corporation is not inclined to take any action to avoid the 21% tax that the federal government will impose on this income. But now a state comes along and will impose a 7% tax on top of the 21%; the corporation is motivated to avoid a 28% rate and acts to reduce its corporate income to $900,000—that is, $100,000 of income has been shifted, say to a low-tax jurisdiction. As to that $100,000, the federal government has lost $21,000 in revenue and the state only $7,000 because its rate is lower.

There is, arguably, a certain rough justice to this state of affairs. After all, given the difficulty states have in taxing mobile capital, but their need to do so if they are to fund themselves somewhat progressively, one might think it appropriate for the central government to help—again, at least to some extent. The federal government did do this explicitly in connection with the estate tax until 2001,54 and until 2017, did so implicitly by means of the state and local tax deduction.55 In the case of the estate tax, the federal government

administrative burden of states maintaining a corporate tax on their own in addition to a federal securities tax would be excessive. For an important proposal for a securities tax, see Mark P. Gergen, How to Tax Capital, 70 TAX L. REV. 1 (2016).


made it essentially free for states to impose an estate tax up to a certain amount. In the case of other state taxes, and in particular, the state income taxes, the federal deduction meant that states had their taxes subsidized more as those taxes became more progressive. That is, the more states taxed taxpayers in higher income brackets, the bigger implicit subsidy the state would receive.

Note that a fun corollary to this point is that to the extent that states can find ways to tax corporate income along different margins from the federal government, the federal government should be happy that they are doing so because such an approach reduces tax cannibalization. That is, if a state has a choice to raise money from either increasing state corporate tax rates or otherwise broadening their tax bases, then, all else equal, the federal government saves money if the states broaden their bases rather than increase their rates.

The fourth reason for bolstering the state corporate income tax builds on the argument so far. Suppose that the federal government were providing a robust safety net, financed by redistributive taxes and, during recessions, debt. In such a scenario, one might wonder if the states should pursue the excess returns of corporations—even if, as I have argued so far, they could. The corporate tax is relatively expensive to administer and cannibalization does reduce national welfare. Furthermore, the relatively stable tax bases assigned to states and localities (sales and property) should perform well, if well designed, in providing core state and local services, such as education and public safety. These needs do not go down or up dramatically in a recession and, fortunately, these bases do not generally shift much either.

Yet the federal government does not provide such a safety net. The net that is provided must be supplemented by the states and localities, meaning that the needs of these governments go up just as their revenue goes down. And states and localities cannot borrow in the same way that the federal government can. The states could eschew these additional burdens, at least in some cases, but I do not consider this realistic for any state given, for instance, the structure of the Medicaid program. I certainly would not consider a state opting not to participate in vital safety net programs to be just. In any event, such an approach is completely off the table during the current crises. Given therefore that states will need more money in

recessions, they should be socking away revenue from more volatile sources, like the CIT, during the good times. It is thus particularly consonant with the peculiar American federal system that the states tax mobile capital.

To be sure, there are potent objections that such prudential fiscal management will not be possible as a matter of politics, but it turns out that politics is not always so shortsighted. For example, California’s Proposition 2 manages to direct revenue from a volatile source (capital gains) into a reserve fund.

The fifth and final reason in favor of the state corporate income tax is that it could perhaps be designed to supplement federal attempts to combat income stripping (or shifting). Though the details of the problem are contested, there is little doubt that a major driver of the decline in the federal and state corporate tax base results from income shifting. Indeed, as will be discussed below, two major provisions of the TCJA, a Republican bill, address income shifting. Income shifting occurs when profits are shifted from the high-tax jurisdiction in which they were earned to a low-tax jurisdiction. A classic—simple—type of income stripping involves the location of intellectual property. A corporate taxpayer develops valuable IP in a high-tax country, say the U.S., and then transfers that property to a subsidiary in a low- or no-tax jurisdiction. The subsidiary then charges the rest of the corporation high prices to license its intellectual property, with the result that the corporation taxable in the high-tax jurisdiction has low profits, while the subsidiary in the low-tax jurisdiction has high profits. Note the artifice here; the intellectual property was developed in the high-tax jurisdiction and most of its customers are in the high-tax jurisdiction, and yet that jurisdiction only has a claim to a small slice—if any—of the overall business’s profits.

To the extent a change to state corporate taxes reduces the incentive for income stripping, that is another efficiency gain. That is, income stripping is costly not only because it erodes the tax base, but because it is wasteful as a result of the time spent on planning (and enforcement) and because of the misallocation of capital resulting from the fact that not all firms are equally situated to benefit from income stripping.

59. CAL. CONST. art. XVI, § 20.
60. On shifting out of the federal base, see Gravelle, supra note 4. For state conformity to the federal base, see BRUNORI, supra note 25.
61. Infra Sections III.A–B.
III. THE STATE CORPORATE INCOME TAX IN PRACTICE

Thus far I have argued that there is a practical need for states to tax mobile capital and presented theoretical arguments that they should do so under certain conditions, but do they have the tools to do so? In particular, do states have the tools to tax corporate income on some different margin than that taxed by the federal government? Can that additional margin also combat income stripping? Can that margin also target excess returns? The short answer is that the state corporate income tax has developed—and can develop—in potent ways consistent with the preconditions set by theory.

The first important development has been the shift to the single sales factor (“SSF”) as a tool to apportion income. The location of a corporation’s customers is relatively immobile and thus shifting to SSF makes sense for the same reason that relying on sales taxes makes sense. In short, the shift to SSF means that state corporate income taxes are taxes on a less mobile base than is commonly imagined.

Second, the changes to federal tax law have created numerous opportunities for states to tax corporate income along somewhat different margins than those taxed at the federal level.

For example, consider depreciation. The new federal law concerning depreciation permits 100% depreciation for investment in capital assets through 2023 (and is still generous after that). States are wisely not conforming with this rule because it would be expensive to do so, but why not conform strategically—that is, make money by slowing down state-level depreciation? As a matter of income tax principle, better matching of tax depreciation with real economic depreciation makes sense. Further, as a matter of policy, the entire notion that bonus depreciation will spur investment has been quite strongly contested. In any event, even if the new depreciation rule is justified as spurring capital investment, it is unlikely that the additional spur of a pumped up state deduction for depreciation is justified.

To make matters concrete, suppose a capital investment is $1,000,000; given the 21% rate at the federal level, this deduction is worth $210,000 to

64. To be sure, revising state income taxes to be better income taxes is not entirely consistent with making state corporate income taxes better at taxing only excess returns.
the taxpayer. Suppose as well that the taxpayer otherwise had $1,000,000 in net income and thus the depreciation deduction eliminated its federal tax liability.

Now consider what happens if a state imposes a more realistic depreciation schedule, say flat line depreciation over ten years. This means that the taxpayer can only depreciate $100,000 in the current year, leaving $900,000 to be taxed. Even if all states taxed the $900,000, then that would result in a tax liability of $63,000 (assuming an average rate of 7%). The additional state tax bill is still much smaller than the federal incentive and thus is not likely to slow down any firm anxious to accelerate capital expenditures in order to take advantage of the TCJA. But most states will not respond in this way. If California did, then it could likely tax no more than, say, 13% of $900,000, which at California’s actual 8.84% rate nets California about $10,000. This might be quite significant for California but is even less likely to affect the decisions of the taxpayer.

A. GILTI OPPORTUNITY

But is there an example of a federal change that opens up a new margin for the states and (at least in theory) counters income stripping? Yes, there is: the states can conform to the new GILTI regime. The essence of how the GILTI rules work is by identifying foreign assets that are unusually profitable by means of a formula, then subjecting that income to U.S. tax—but at 50% of the regular rate—even though the income is nominally earned abroad.66 And there are assets and people in certain low-tax jurisdictions that seem to produce gigantic amounts of reported income relative to similar assets in other jurisdictions.67 Here is a chart illustrating the point:


67. Thomas R. Torslov, Ludvig S. Wier, & Gabriel Zucman, The Missing Profits of Nations 19 (Nat’l Bureau of Econ. Rsch., Working Paper No. 24701, 2018) (“Foreign firms in tax havens are an order of magnitude more profitable than local firms, while foreign firms in other countries are less profitable than local firms. That is, there is a clear trace in global macro data of movements of profits within divisions of multinational groups, away from high-tax affiliates and towards low-tax affiliates.”).
Of course, workers in the jurisdictions on the left of the above chart are not really more profitable; rather, the excess profitability is just an artifact of income shifting. There is room to debate, of course, how well the provision of GILTI tracks the excess return thrown off by these assets, but the theory that there are such “super” assets is a strong one.

For another striking set of data, consider the following:

68. Id. at fig.4.
There is no substantive way in which a jurisdiction’s economy can produce profits many times its GDP; these profits were shifted to these jurisdictions and for an obvious reason: to pay less corporate tax.

The case for states to conform their corporate income taxes to the federal base as to GILTI is straightforward: here, at long last, is a federal provision meant to protect the domestic corporate tax base from erosion. Furthermore, the idea that income shifting will leave a trail of super assets is clearly reasonable. Whatever GILTI’s (many) flaws in execution, surely the states should seek to claw back as much of their base as possible. Indeed, GILTI is in many ways not so much meant to counter the base erosion that has already happened, but the base erosion that is feared will occur on
account of the shift to a (more) territorial tax system at the federal level. That is, until the passage of the TCJA, the federal government taxed the worldwide income of corporations, at least in theory. With the passage of the TCJA, this is not even theoretically the case and so corporations have an even greater incentive to shift income abroad. Viewed from this perspective, if states do not conform to GILTI, then they are signing up for further erosion of their corporate tax bases. Furthermore, to the extent that one reason that GILTI is likely to be ineffective is that it is still subjecting shifted income to a rate lower than the regular federal corporate rate, state taxation of GILTI is making the federal provision better.

Clearly, taxing GILTI is broadly consistent with the goal of taxing excess returns, but, at first blush, it seems to be a simple question of conformity. There does not seem to be any particular federal misstep that the states would be taking advantage of, but this is, in fact, not the case. To see the mismatch, we must march deeper into the heart of the GILTI.

GILTI provides an 80% foreign tax credit. As a matter of theory, this makes some sense if we observe that the concern is not with moving income per se, but with moving income to where it will be lightly taxed. Again, one critique of the GILTI regime is that it subjects GILTI to a 50% lower tax rate and therefore the rate at which a foreign country needs to tax GILTI in order to zero out U.S. liability is relatively low (13.125%). Still, this choice too can be justified on the argument that the GILTI regime is a move in a multijurisdictional game that is trying to move nations to a minimum tax rate on mobile capital. A 13.125% rate everywhere would be quite a positive

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74. I say broadly for many reasons, including that a corporation has incentive to shift normal returns too. Hence the importance of the background fact that corporate returns are increasingly excess returns and it is the corporations that generate the most excess returns that seem most inclined and able to shift income. This makes sense, as it is the possession of income from intangibles, for example, from IP, that simultaneously creates the excess returns and enables easier shifting of those returns.
Even if one were to go this far in sympathy with the use of foreign tax credits, GILTI allows cross crediting between countries, thereby significantly undermining the extent to which it is really impelling nations to adopt a minimum tax. This cross-crediting feature of GILTI will likely undermine both its revenue raising and income stripping deterring potential.

States do not offer foreign tax credits, and here, then, is the federal misstep that states can avoid and improve upon. Suppose a firm has an enormous amount of GILTI because it has relatively few assets abroad, but a great deal of income. In other words, it looks like this MNC has shifted substantial income. Suppose as well that this MNC dramatically reduces its GILTI liability because it pays just enough in higher tax countries to end up with a 13.125% rate overall. GILTI has not done much more than helped, say Germany, raise a little bit more in its corporate income.

Yet at the state level, the tax credits will not matter. Rather, the states will use a reasonable apportionment formula to apportion some fraction of the taxpayer’s GILTI to the state. So, for state purposes, the MNC will have a large amount of GILTI pulled back into the state tax base and the manipulation of foreign tax credits will not have helped at all. This is the strategic opportunity for states to tax the mobile income of MNCs.

B. OTHER OPPORTUNITIES: THE BEAT

There are numerous other opportunities for the states beyond those discussed in this Article. For example, the TCJA contained another mechanism meant to combat income stripping. As with GILTI, the TCJA drafters might have spent more time on the acronym than the details; this provision is called Base Erosion and Anti-Abuse Tax (or “BEAT”). Also, as with GILTI, the core insight animating the BEAT provision is conceptually sound. Let’s return to our classic example of income stripping. It features a foreign jurisdiction with a lot of profits, but few assets (the target of GILTI), but also payments between related entities in order to strip the income from

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76 (2018).
78. And there is good reason one might not. For instance, one might believe that the chosen rate is too low. One might also wonder why the United States, by use of tax credits, is making sure that tax is paid to other jurisdictions, many of which are high income and presumably not in need of our help. This latter question is even more relevant as to states; why should a state help set a minimum tax for the benefit of, say, Germany?
79. See Kysar, supra note 72, at 344–47.
80. Id.; Clausing, Profit Shifting Before and After TCJA, supra note 73, at 2–3, 14.
the high-tax jurisdiction. This is the target of the BEAT. Basically, the BEAT is a minimum tax, like the alternative minimum tax (AMT) for individuals. Certain intercompany payments are disregarded, which will generally mean that more income remains in the United States; this larger tax base is then subjected to a lower tax rate (10% versus 21%). If that BEAT tax liability is greater than the ordinary liability, then the taxpayer pays the BEAT liability.

As a measure meant to protect the federal corporate tax base, there seems no reason why states should not conform to the BEAT to protect their corporate tax bases as well. Note that, as with GILTI, there are multiple—and administrable—ways in which states might improve their state-level BEATs. For instance, commentators have noted that the BEAT regime only kicks in for very large MNCs ($500 million in gross sales) and that base erosion is also occurring at smaller firms.81 A lower threshold would therefore make sense.

Despite the numerous other levers the states should consider, the focus of this Article will remain on GILTI in order to keep the analysis tractable. Further, as will be argued in the next Section, states that conform to GILTI are implementing a particularly elegant response to the problem of income shifting.

C. MORE ON THE GILTI OPPORTUNITY: THE ISSUE OF APPORTIONMENT

States should conform to GILTI to protect their corporate tax base. Further, to the extent the states do not offer the use of tax credits but rely on apportionment formulas, then this has the additional benefit of amounting to strategic conformity. Of course, states could conform to the federal credits or improve the credits by having them apply on a country-by-country basis.82 To return to our example of a taxpayer which has reduced its federal liability for GILTI by means of tax credits, why should that taxpayer still have substantial liability at the state level? The argument that the additional state liability is justified because of the poor design of the federal credits only goes so far if, as is possible, the use of apportionment produces a sounder result than would result from better designed credits.

The answer is that apportioning GILTI is superior to the use of credits, even on a per-country basis or, at the very least, using apportionment instead is on very strong independent ground. Thus, the states should use apportionment not only because it is strategic, but also because it is a good

81. See Kamin et al., supra note 71, at 513.
82. Note that this reform was challenged at the federal level as too onerous and so one can only imagine how it would go over at the state level. See Shaviro, Part 2, supra note 66, at 178.
choice independently of what the federal government might do (and, after all, the federal government could choose to use apportionment).

A little history as to the cutting edge in corporate tax is helpful here. In 2009, Avi-Yonah, Clausing, and Durst proposed reforming the international corporate tax system by separating out routine returns and then apportioning excess returns. In 2019, Devereux et al. proposed a very similar system, but using somewhat different methodology to calculate normal returns and then how to apportion the supranormal returns. The OECD is now formally considering a version of these proposals as central to combating base erosion and profit shifting.

The difference in the methodologies is not important for our purposes here so much as the basic two-step proposal: first, divide up types of returns, then apportion the excess returns.

The federal GILTI regime, however imperfectly, represents a mechanism for separating different types of returns, and state apportionment regimes are a method for apportioning excess returns. In short, the state approach to taxing GILTI is not just reasonable as a strategic choice given the previous choice made by the federal government, but also a better choice that approximates the cutting edge in thinking about the corporate tax. Why is this the cutting edge? The key insight is that nations (or states) should use an easy—and relatively nonmobile—factor to apportion the most mobile kind of income: excess returns. The location of a taxpayer’s consumers is thought to be both relatively easy to administer and hard to game.

A note about ad hocery. As someone who thinks a lot about tax policy, it clearly matters to me that this proposal—state conformity to GILTI but

83. Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 525–26 (2009). Avi-Yonah and Clausing have—very recently—renewed this argument at the federal level and, in their defense of sales factor apportionment, present many (not all!) of the arguments in this Article. See generally Reuven S. Avi-Yonah & Kimberly A. Clausing, *Toward a 21st-Century International Tax Regime*, 95 TAX NOTES INT'L 839 (2019) [hereinafter Avi-Yonah & Clausing, 21st-Century]. In particular, they respond to the objection that the sales factor can be easily gamed. Note that, if the United States did shift in this way, then it would make sense for the states to follow, but the advantages from strategic non-conformity would not accrue to the states.


86. Devereux et al., supra note 84, at 3.
using apportionment rather than credits—has theoretical bona fides because I believe that theory has a lot to teach us. But I do want to be sure to note that theoretical purity is not the be all and end all. After all, it is well understood that our income tax system is actually a hybrid income-consumption tax. It is also well understood that our tax system deviates from any theory of taxation in many cases in order to, in effect, spend money. And these deviations are defensible. For example, if the income tax system is measuring income anyway, then it makes sense for certain programs based on income to be administered through the tax system.

And sometimes the theoretical basis of a tax is even more attenuated. After all, no one is entirely certain where the incidence of the corporate tax ends up; it is likely a tax on a shifting percentage of capital and labor. Texas has a tax, the Margin Tax, that allows the taxpayer to choose the tax base it prefers, and so it is incoherent by design. Still, the tax raises revenue from some combination of taxing consumption, labor, and capital, and maybe that is enough. As Ed Kleinbard has emphasized, we raise revenue in order to spend it on public goods. We need to raise enough and we should like to raise enough with as little distortion as possible. Sometimes, following a pure theory—say tax consumption—is the way to achieve these goals. But, in most cases, after a tax has been run through the political process and subject to all manner of historical accretions, the result is not theoretically pure. Thus, suppose that layering apportionment onto GILTI were not theoretically coherent, but was effective as a means of taxing capital, why shouldn’t that be enough?

88. Id.
89. TEX. TAX CODE §§ 171.0001–909 (West 2020). Specifically, a firm can choose total revenue minus cost of goods sold (that is, close to subnational subtraction method VAT) or total revenue minus compensation (that is, an inversion of the correct VAT calculation) or 70% of revenue or total revenue minus $1 million (a boon to small business). Franchise Tax Overview, TEX. COMPTROLLER OF PUB. ACCTS., https://www.comptroller.texas.gov/taxes/publications/98-806.php [https://perma.cc/3AZG-CUNE].
IV. OBJECTIONS

The theoretical objections to the state taxation of mobile capital have been addressed, at least implicitly, because it has been demonstrated that state taxation of corporate income can be much more efficient than the traditional analysis would allow. In the remainder of this Section, I will address some additional objections.

A. OBJECTION BASED ON GILTI BEING A FAILURE

The CBO has recently lowered its low estimate for how effective it expects GILTI and the BEAT to be.91 This is in part because corporate interests have been quite successful at lobbying the Treasury Department for very favorable regulations.92 And so, if GILTI is expected to be such a failure, why should states bother?

These facts actually cut the other way. This is because states need not conform to Treasury regulations that give away the store. And so states simply should not conform to the so-called high-tax exclusion election.93 Furthermore, there are giveaways located in the regulations relating to the provision of foreign tax credits, and states need not worry about these so long as they do not provide tax credits.94 The large amount of revenue the states are projected to stand to gain from conforming to GILTI assume they do not provide foreign tax credits nor conform to the high-tax exclusion election.

B. OBJECTION BASED ON ADMINISTRATIVE BURDEN

Conforming to GILTI does add more complexity because there are additional state-level considerations, particularly issues of apportionment, but these do not appear excessive given a baseline of MNCs already apportioning all of their U.S. income for the purposes of state corporate income taxes. It would be one thing if a state imposed something like the GILTI regime on MNCs on its own, with other states using fundamentally different methodologies, but the proposal here conforms to GILTI and then, at most, tweaks discrete portions (disallowing an election permitted by the regulations) and/or simply apportions the result, like any other state

91. CONG. BUDGET OFFICE, supra note 5, at 73–74; see also Jacoby, supra note 73, at n.3.
94. Id. at 1133.
conformity to an expansion of the base. It is also the case that we are talking about taxpayers that have significant operations both across the United States and abroad; such taxpayers seem well positioned to cope with a little more complexity.

C. UPSETTING A CAREFUL BALANCE?

Traditional discussions of international tax policy assess what an optimal policy would be. For example, on the one hand, it makes sense to tax all corporations that invest in the United States at the same rate. On the other hand, it also makes sense to enable our national champions to compete abroad at rates no worse than foreign competitors. Satisfying both sensible goals is impossible, at least in the world as it is. Suppose the U.S. corporate tax rate is 35%. We want both Apple and a purely domestic business to pay the same 35%. And yet, say Apple wants to expand in a country with a tax rate of 20%. Do we want Apple to be at a disadvantage? There is no a priori right answer to these questions, especially since the various jurisdictions (and major taxpayers) strategically respond to the actions of the other.

As Dan Shaviro puts it, we are looking for something of a Goldilocks solution. We want fairness between different firms domestically, but not so much so as to weaken our firms’ ability to compete internationally. Perhaps surprisingly, Shaviro argues that tolerance of income shifting is perhaps a part of the solution. Everyone pays the same “retail” tax rate, but the more mobile taxpayers can self-help their way to lower rates.

Nothing I have written so far about state tax policy addresses these issues directly. Indeed, because of the general argument above that state corporate tax rates are pretty low, and firms can reduce federal-level GILTI effectively using tax credits, there is not likely to be much of a competitive response one way or the other. Put another way, whatever Goldilocks solution the federal government has arrived at, for better or for worse—and it is always in flux because of strategic responses—the states’ responses on top of it are minor.

This might be seen as something of a cop-out though. Leaving aside the fact that the approach I am espousing could at some point amount to a significant factor for international tax planning, it is fair to ask whether or not the proposal here is shifting matters in a sensible way. It seems to me the answer is a qualified yes. First, to the extent that the GILTI regime is in

96. Id. at 63.
various ways too generous to MNCs and allows quite a bit of income stripping, states conforming to GILTI is helpful in moving the overall regime in the right direction—less income stripping.

More fundamentally though, I accept the Goldilocks analogy but not its specific application to income shifting. It is certainly true that we do not want to impose such a rigorous—or faux rigorous—method for locating income that we impose a huge burden on taxpayers. Some gaming is the cost of administrability. Also, it is ideal to impose lower rates on more mobile taxpayers, all things equal, but to do so through permitting income stripping does not seem like the way to go. Obviously, there are the issues of tax morale and the huge transaction costs these games impose. More fundamentally though is that, like the classic corporate tax shelters of the 1990s, there is no limit to the extent an income shifting strategy can succeed. If a mobile firm can shift its IP so as to reduce its tax by 50%, why not 100%?

There is a “better” way, one that the federal government and states use all the time and that is giving tax credits to firms who do what the government wants (for example, hire in certain locations) or, more relevantly here, have certain characteristics (for example, invest heavily in research and development). These tools are far from perfect, but at least they let the governments decide just how much of a break to give to which type of firm. Again, this is not to say that governments should seek to eliminate all income shifting, just that the argument for taxing more mobile firms at a lower rate does not indicate that we must allow significant income shifting. We can try to do much better at combating income shifting while using other tools to keep “our” most mobile MNCs competitive globally.

D. POLICY OBJECTIONS BASED ON THE SINGLE SALES FACTOR

It could also be objected that the use of the single sales factor, for all its appeal in theory, has been undermined in practice. Specifically, numerous studies have shown that the shift to SSF leads to a reduction of the state corporate tax base, a result that makes sense on the theory that actual sales might not be mobile, but the location of sales for purpose of the sales factor might be quite mobile as a result of tax planning.97

There are two basic types of planning structures that undermine the sales factor, one real, one imagined.98 The structure that is definitely in use

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97. I discuss the evidence and possible reforms in Shanske, Fiscal Capacity, supra note 34, 487–99.
is to have intermediate sales made to a low-tax or no-tax state, with final sales made by intermediaries into a high-tax state. The result is that the intermediate sale of the primary taxpayer, which realizes most of the value, escapes going into the high-tax state’s sales factor. Instead, those sales go into the sales factor of the intermediary business with a much lower margin that actually completes the sale in the high-tax state.

As for this stratagem, the states have several tools they could use to respond. The primary tool that states can and should use is to apply an ultimate destination rule. Such a rule is in increased use among the states in connection with sourcing services and intangibles; states should take the next step and apply this rule for the sale of tangible personal property as well. Such a rule ought not be terribly burdensome. After all, in the usual course of business one would expect a manufacturer or service provider to know where its work product is going. To the extent not, there can be various backup presumptions. States already employ these presumptions for sourcing the sales of intangibles and services; they should now use them for sourcing tangible personal property as well.99

The imagined horrible is for a high-profit, but low-volume, MNC to purchase a business with low profit, but high volume, so as to shift income. Imagine Apple purchasing a supermarket chain in India. To imagine it is to see the many logistical hurdles. It makes little sense for an MNC to undertake such an endeavor given current state-level tax rates. Even if such a scheme ever did make sense, it would likely be futile. State apportionment law already gives state taxing authorities the ability to alter standard apportionment formulas if they arrive at a result that does not “fairly represent . . . business activity within the state.”100 In the leading case, the California Supreme Court permitted the Franchise Tax Board, in effect, to separate Microsoft’s software business from its treasury function.101 The treasury function, with its high volume and low return relative to the rest of a qualitatively different business, was easy to distinguish—and a grocery


99. For the story of how states ended up with a more rigorous approach to intangibles and services as compared to tangible personal property, see Shanske, Fiscal Capacity, supra note 34, at 464–65. In short, states used to have a much worse rule for intangibles and services as compared to tangible personal property; they have now updated their rule but left the old, mediocre rule for TPP in place. Avi-Yonah and Clausing propose language for antiabuse rules to achieve the same end. See Avi-Yonah & Clausing, 21st-Century, supra note 83, at app. 848–49.


chain would have been even more so.

E. CONSTITUTIONAL OBJECTIONS TO STRATEGIC STATE RESPONSES

The federal government has decided to encourage capital investment by permitting taxpayers to depreciate capital assets. Can a state really take advantage of this choice and tax capital investments more heavily by slowing down depreciation? Would some kind of conflict preemption not come into play? As I have argued at length elsewhere,\(^\text{102}\) I think the answer is no. Ordinary federal tax statutes do not have the effect of preempting state tax law because such a rule would dramatically undermine the revenue power of the states. The federal choice to encourage capital investment is a very expensive one; it would be extraordinary if that choice now meant that all states also had to permit full expensing of capital equipment.

In fact, the Supreme Court has permitted states leeway in the area of international taxation. The states did not and do not approach the income of MNCs in the same way as the federal government. Among other differences, the federal government, consistent with international norms and treaties, uses foreign tax credits and a methodology called transfer pricing to divide the income of MNCs. Not so the states; they use apportionment. Taxpayers argued that the states were not free to deviate from the federal government in this way.

However, the Supreme Court held clearly, twice, that the states are not implicitly bound to follow the federal government even in a context where the taxpayers could plausibly argue that the harm from nonconformity had reverberations beyond other state-federal differences.\(^\text{103}\) And this makes sense. Given the relative import of MNCs, requiring states to follow the federal lead “only” as to their international operations would amount to a serious limitation on state revenue power.\(^\text{104}\)

\(^{102}\) See generally Shanske, Respond Strategically, supra note 14.


\(^{104}\) There is a separate question of whether Congress could explicitly preempt the states so that they had to conform to federal tax law. I address this question at some length in Shanske, Respond Strategically, supra note 14, at 554–56, but the upshot is that I think that Congress could preempt the states as to narrow questions, but not on the overall design of their tax systems. Where a particular proposal would fall could be a hard question, but since Congress has only ever acted in a narrow way to date, there are no cases on point.
F. CONSTITUTIONAL OBJECTIONS TO THE SINGLE SALES FACTOR

The requirement that states apportion income emerges from the sensible rule, grounded in the Due Process Clause and dormant Commerce Clause, that a state may not tax extraterritorial value. As a matter of showing sufficient nexus, California can surely tax Apple, but so too can New York. If California, New York, and every other state with nexus (that is, all states) tax Apple on 100% of its income, then Apple will be taxed on 5,000% of its income (50 multiplied by 100%). Hence the need for each state to come up with some reasonable slice of Apple’s income. Note the “reasonable” here. As the Supreme Court has recognized since the late nineteenth century, such formulas can only ever be reasonable surmises.105

There is an argument that the shift to using only the sales factor for purposes of apportionment falls below the level of reasonableness. This argument proceeds as follows. States can use formulas to locate the source of income, and the formulas might be imprecise, but they need to make a better effort than the sales-factor-only formulas. Let’s go back to Apple. It seems reasonable to argue that its customers generate its profits, but so too must Apple’s employees and equipment. Yet the sales-factor-only formula does not take the location of employees or property at all, and hence the formula is unreasonable.

Note that the argument cannot be that the sales factor formula necessarily leads to double taxation because it would not. If every state divides up the corporate tax base using sales, then we do not have the double taxation problem. The argument also cannot be that the location of a sale does not have a legitimate claim to tax the sale; sales taxes do this all the time. But those are, of course, sales taxes, and so this objection, properly understood, is that an income tax must use an apportionment formula that is at least fairly trying to locate income.

Once refined, this objection in essence makes theoretical purity a constitutional requirement, but why should it be? To take an easy example, let’s go back to Texas’s Margin Tax. It is a theoretical mess; does that make it unconstitutional? I have never seen anyone argue that. If it is constitutional, then it must be apportioned. Texas uses just the sales factor and presumably does so because, independent of the nature of the base of the tax, the sales factor makes sense. It makes sense because, at least in theory, it is the least mobile factor. A firm might move its headquarters out of Texas, but presumably cannot move its customers.

To return to the corporate income tax, it is hard to see why states should be penalized for retaining a tax on a coherent base and then using an apportionment method most consistent, by their lights, with maintaining that base. If states must have an incoherent base to choose the most stable formula (SSF), then they can all adopt a form of the Margin Tax.

But note that using SSF with a corporate tax is not, in fact, entirely incoherent. Indeed, the federal government is leading the way in transforming the corporate income tax into a consumption (that is, a sales) tax. The main way the federal government is doing this is through permitting expensing of capital equipment. To the extent a state agrees that this transformation makes sense, then using the sales factor is the theoretically consonant way to divide the corporate income tax base because, by design, the base itself is now a hybrid income-consumption base.

In the end, it turns out that the Supreme Court upheld the use of single sales factor apportionment in 1978, though it did not directly address the argument that the single sales factor is fundamentally impermissible. It seems doubtful that the Court would revisit the precedent and, based on the arguments above (and elsewhere), it seems very likely it would come to the same conclusion again.

G. CONSTITUTIONAL OBJECTIONS TO CONFORMING TO GILTI

But can states conform to GILTI? The fundamental principles of constitutional law indicate that they can and, at this point, there is little debate about that. There is vigorous dispute about how states can conform, not whether they can. See Frieden & Donovan, supra note 10, at 1077.

Demonstrating why this is so will require a bit more context.

107. In MNC representatives’ most recent arguments against state conformity, the argument is with how states can conform, not whether they can. See Frieden & Donovan, supra note 10, at 1077.
108. Frieden & Donovan, supra note 10, at 1078. Even if these objectors are correct about the required formula, it is probably still on balance worthwhile for states to conform to GILTI precisely because the prevalence of income shifting will likely bring in more income than the additional factors will cause dilution.
1. Additional Constitutional Background

To review, in order to determine how much of the income of a multijurisdictional enterprise can be fairly apportioned to a state, a state is permitted to use a reasonable formula for approximation. The burden on the taxpayer challenging the formula is then heavy, as the taxpayer must “prove ‘by ‘clear and cogent evidence’ that the income attributed to the State is in fact ‘out of all appropriate proportions to the business transacted . . . in that State.’” , “109

Additionally, in deciding how much income of a conglomerate enterprise a state can choose to subject to its formula, the state is limited by the unitary business principle.110 The intuition behind the unitary business principle is straightforward, even if its application isn’t always so. Apportionment is appropriate because we do not know where a single business, say Apple or a railroad, earns its income. Suppose Apple decides to make a passive investment in a sheep farm in New Zealand. Unless there is some connection to Apple’s main technology business, the sheep business is not unitary with Apple’s main business and its income should not be apportioned. States are permitted by the unitary business principle to include the (operational) income nominally earned abroad in their formula approximations, so long as the foreign businesses are engaged in a unitary business.111

The Supreme Court has applied these principles not only to bless the division of corporate income, but also the division of corporate deductions. Consider the facts of Hunt-Wesson, Inc. v. Franchise Tax Board.112 In that case, the Court struck down a California rule that ascribed all interest expense first to nonunitary businesses.113 The Court held that this rule went too far.114 Nevertheless, the Court understood that California had enacted this rule in order to counter a real problem, namely the difficulty of ascertaining whether an interest expense was really undertaken in order to reduce income of a California business that would otherwise be taxable by California. Thus, the Court went out of its way to bless “ratio-based rules” used by the states and the federal government in this (interest) context and also in other similar

113. Id. at 460.
114. Id. at 466.
Up to this point, the analysis as to the GILTI inclusion is rather straightforward. So long as an MNC is conducting a unitary business, then GILTI income can be included in the base that the states can divide by apportionment. The primary challenge is constructing a reasonable formula. One problem is that if a state just includes all the sales of the foreign subsidiaries of an MNC—controlled foreign corporations (“CFCs”) formally—in the sales factor, then a state might well be unreasonably diluting the percentage of income it is entitled to tax. Remember, the whole—sound—notion behind GILTI is that it is a tool for finding income that was not earned where a taxpayer says it was. Thus, the states need to use a reasonable formula, but that formula need not include all the sales of the CFCs in exactly the same way as the formula accounts for domestic sales.

2. The Objection, Finally

Yet there is an argument that any different formula for nominally foreign income fails under the foreign dormant Commerce Clause. If this argument is correct, then if a state uses the sales factor to apportion domestic income, then it must use the sales factor in the exact same way in order to apportion GILTI. This would mean including the sales of all the foreign subsidiaries. This argument relies on a case called Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance.116

*Kraft v. Iowa* is not actually about apportionment. The state in *Kraft*, Iowa, was a separate reporting state.117 Following the federal definition of taxable income, Iowa taxed dividends received from foreign subsidiaries but not dividends derived from domestic subsidiaries. Despite several arguments in favor of the Iowa structure, including administrative convenience and the fact that this structure does not have any protectionist impact,118 the Court struck down the Iowa law as facially discriminatory against foreign commerce.119

The argument from leaders of the private SALT bar is that *Kraft* established a rule that a state cannot treat foreign-source income less
favorably than domestic-source income. Applied to the GILTI question, these commentators have argued that GILTI is foreign-source income and, as such, must be apportioned just like domestic-source income or else this would result in impermissible discrimination under Kraft. However, even before further analyzing Kraft, the notion that states must simply take corporations at their word as to where income is generated is a surprisingly prescriptive conclusion and one that runs against the mass of precedent that gives states considerable leeway in taxing multijurisdictional enterprises and makes clear that they specifically do not need to take the corporation’s word on it. This leeway makes sense given the respect the states are due as sovereigns trying to exercise one of their core functions, namely raising revenues.

Moreover, there are multiple flaws with this argument as an interpretation of what Kraft demands with respect to GILTI income. First, the Iowa statute at issue in Kraft was based on a simple binary—the income in question would either be subject to tax or exempt from tax. There was thus no discussion in Kraft of whether having a different apportionment formula for foreign-source income would be permissible. As explained already, the general constitutional rules governing fair apportionment grant the states considerable leeway in designing their formulas. So, for instance, if states can apportion the income of financial services companies differently and, relatedly, can add-back suspicious deductions or can have special water’s edge rules for income earned in tax havens—and none of this has been deemed constitutionally problematic—then it seems clear that Kraft should place no bar to states applying some special formula for GILTI income so long as that formula uses a reasonable method for approximating how much of that GILTI income should be apportioned to the state.

Second, the Court in Kraft emphasized that it was treating the dividends at issue in Kraft as foreign-sourced: “[T]he only subsidiary dividend payments taxed by Iowa are those reflecting the foreign business activity of foreign subsidiaries.” Thus, the Court did not reach the question of whether it would be constitutional for a state to treat some portion of

120. See, e.g., Frieden & Donovan, supra note 10, at 1089; Donovan et al., supra note 10, at 318.
121. Frieden & Donovan, supra note 10, at 1089; Donovan et al., supra note 10, at 318. That is, a state may choose to use separate accounting, but there is no constitutional requirement that it do so. Exxon Corp. v. Dept’ of Revenue, 447 U.S. 207, 222–23 (1980).
122. As the Supreme Court has explained, there is a “strong background principle against federal interference with state taxation.” Nat’l Private Truck Council, Inc. v. Okla. Tax Comm’n, 515 U.S. 582, 589 (1995).
nominally foreign earnings as actually earned domestically.125

It could be argued that the states are constrained by the fact that the federal government respects the income earned by CFCs as foreign, but this argument is also flawed. First, the Supreme Court has already held that the states are not bound to follow the federal treatment of the income of MNCs and can use their own reasonable formulas to apportion income,126 nor must the states follow the elements of federal corporate tax law generally. Indeed, the latter point was part of the holding of Kraft. If Iowa had to conform to the federal dividend received deduction rule, then it could hardly be found to have violated the foreign dormant Commerce Clause for doing so.127 Second, as a matter of fact, the federal GILTI regime signals that the federal government does not, in fact, believe some substantial portion of GILTI is foreign-sourced.

The upshot is that, returning to our example, a state is not required blindly to take in both GILTI and the factors of the CFCs that generate GILTI. Rather, states must approach the manner reasonably. One reasonable approach would be to estimate what share of GILTI represents income shifted out of the US; the states could then apply their regular apportionment formula to that income. Thus, to be concrete, a state might argue that 35% of all GILTI income is displaced from the domestic base.128 So, if a firm has $1,000,000 of GILTI, then $350,000 is to be treated as U.S. income. A state could then ask the taxpayer to apportion that $350,000 based on the apportionment factor it would otherwise have. So, for example, if a taxpayer had a 10% factor not including GILTI, then $35,000 of GILTI (10% of the amount deemed domestic) would be taxable in the state.

There are other reasonable approaches. Consider the use of the apportionment factor for income other than GILTI income. GILTI income represents, at least in part, excess returns that have been shifted out of the domestic tax base. It is not unreasonable just to apportion these returns to the

125. For similar—and very thorough—further development of this argument, see Michael T. Fatale, Foreign Commerce Clause Discrimination: Revisiting Kraft After Wayfair, 72 BAYLOR L. REV. 47, 101–11 (2020). Fatale also makes the persuasive case that Kraft was incorrectly decided altogether. See id. at 91–101.
127. Kraft, 505 U.S. at 82.
128. See, e.g., Alex Cobham & Petr Janský, Global Distribution of Revenue Loss from Tax Avoidance: Re-Estimation and Country Results, 30 J. INTEGR. DEV. 206, 231 tbl.A-2 (2018) (finding 37% of revenue loss globally out of the United States). Grubert & Altshuler, supra note 70, at 681, think a 50% estimate is reasonable because of the likelihood that a U.S. MNC did most of its research and development in the United States. Keep in mind that GILTI applies only to U.S. shareholders of CFC.
location of sales, but one might argue instead that a better proxy for the location of these sales is state GDP, at least if a taxpayer has made sales beyond a certain threshold. In general, one would expect the sales factor and state share of GDP to be about the same, but a state could reason that GDP is better because it is a better indicator of where profits, particularly excess profits, are generated. That is, all else equal, one would expect firms to make more of their profits where taxpayers are less price sensitive and, again, all else equal, taxpayers tend to be less price sensitive when they are wealthier.

H. BUT ISN’T GILTI INCOME JUST SUBPART F INCOME (AND STATES DON’T TAX SUBPART F INCOME)?

Ok. This objection will also take a moment to tease out. The thrust of the objection is that subpart F income is a type of foreign income for federal tax purposes that is not currently taxed by many states (definitely not all). Furthermore, the GILTI provision is placed in the subpart F portion of the Code and uses some of the subpart F framework. Since states do not tax subpart F, the argument goes, then why should they tax GILTI? After all, the authors of the TCJA placed the GILTI provision under the same overall umbrella.

To the extent the answer is based on where GILTI is placed in the IRC, then this argument clearly fails. The states are not bound to treat GILTI as subpart F income just because the federal government does. And, in fact, the federal government does not treat them the same. Indeed, GILTI is an attempt to protect the corporate tax base where subpart F has failed. But perhaps there is some deeper policy reason for states neither to tax subpart F nor GILTI.

The first question is: what is subpart F income? In broad strokes, subpart F income is passive income earned by an MNC. The consequence of income being characterized as subpart F income is that it is subject to immediate U.S. tax and at the full corporate rate. What kind of income of an MNC is not subject to immediate tax? In general, the answer is income actively earned abroad. As to that income, before 2017, that income was not

131. 26 U.S.C. § 7806(b) (2018) (“No inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title . . . ”); see generally Shanske, Respond Strategically, supra note 14.
taxed until repatriated. After 2017, that income will never be taxed.

Why “disfavor” subpart F income? The basic idea appears to have been—and is—that the active income of a business should be taxed at its source, while passive income should be sourced on the basis of a firm’s residence.133 Putting aside the jargon, let’s consider a General Motors subsidiary making cars in Europe for the European market. It makes sense that European countries should be first in line in taxing the income earned through using their resources (for example, roads and so forth) to exploit their markets. Now consider the profits GM is earning from its investments; the notion is that the country of corporate domicile should be first in line as to this revenue.

Taxing the passive income of MNCs was also understood to be a tool to combat base erosion.134 Let’s return to our simple example of income stripping,135 except let’s say that what the taxpayer is doing is trying to strip income out of a different high-tax country, say Germany. And so now there is an IP holding company charging high royalties to a corporate subsidiary in Germany, thereby taking the profit out of Germany. Under the subpart F regime, the royalties of the foreign subsidiary would be subject to U.S. tax (for the U.S. shareholders). For this reason, there is less reason to engage in base erosion to begin with.

In 1997, the US Treasury adopted a set of rules involving corporate classification that, in effect, dramatically undermined the effectiveness of subpart F.136 We do not need to get too far into the details, but if an MNC could eliminate the IP holding company from the example above, then there would be no royalties, just an active business in Germany and that income is not subject to tax.

And so, to return to the question for the states of whether or not to conform to subpart F, the short answer is that they should for roughly the same reason that the states conform to GILTI. States should not miss out on opportunities to broaden their corporate tax base and counter base erosion.137 One distinction is that subpart F income is not as targeted at income stripped out of the domestic corporate tax base. Because of this, the argument for

134. Lokken, supra note 19, at 189–95.
135. Id. at 199–200.
137. To the extent the argument is that states cannot tax subpart F income because of Kraft, then that argument is wrong. See Fatale, supra note 125, at 101–11.
conforming to subpart F on its own is a bit weaker. Yet practitioners can transform GILTI income into Subpart F income and thus conforming to both makes sense because of the real possibility that the GILTI tax base is being narrowed through this gaming.

V. THE NEXT STEP BACKWARDS: MANDATORY WORLDWIDE COMBINATION

Let us take a moment to consider where we are. I have argued that the states should strategically conform to a provision of federal tax law meant to counter base erosion. But returning to the history with which we began, the states already had a method to counter base erosion, namely mandatory worldwide combination. How does strategic conformity to GILTI (and BEAT and other provisions) compare to worldwide combination?

A. BRIEF HISTORY OF WORLDWIDE COMBINATION AND THE WATER’S EDGE ELECTION

States first encountered the problem of taxing large multijurisdictional businesses in the nineteenth century. Railroads would argue that their property value was minimal because they just owned a little bit of land, wood, and iron stakes. The states of course took the position that these pieces of property were part of a larger unified system that was very valuable. The Supreme Court agreed. Thus was born the “unitary business principle,” which permits states to take into account that they are taxing a unitary business even if the value or income of that business is earned in many states.

Acceptance of the unitary business principle immediately led to another conundrum, namely how to divide up the value or income of a unitary business. The Supreme Court adopted a flexible rule, permitting any reasonable formula and placing the burden on the taxpayer to “prove by clear and cogent evidence” that the income attributed to the State is in fact “out of all appropriate proportions to the business transacted... in that State.” Thus, in the case of railroads, a state could apportion the value of a railroad on the basis of the percentage of tracks in the state.

138. Relatedly, a successful subpart F regime might therefore only serve to prevent income stripping from foreign high-tax jurisdictions. A worthy goal that might not be of great interest to states. Shaviro, Part I, supra note 95, at 67.


In these early cases, the question was how to apportion the value or income of a single corporation. But what if a business operated through multiple corporations and had its own internal method for attributing income to its different corporations? Did states have to respect this separate accounting, or could a state insist that these different corporations were all part of the same unitary business and thus the income of all the corporations needed to be combined and apportioned? Again, the Supreme Court adopted a pragmatic rule and held that so long as the overall business was unitary, then the states could combine different corporations.\footnote{142} This is called combined reporting.

As businesses became more international, the question arose whether a state could use combined reporting even as to foreign corporations so long as they were engaged in a unitary business with domestic corporations. The answer again was yes. This is true in the case of a domestic U.S. corporation with foreign subsidiaries\footnote{143} and true for a foreign corporation with U.S. subsidiaries.\footnote{144}

The lead decision authorizing mandatory worldwide combination came down in 1983.\footnote{145} Shortly thereafter, foreign governments, particularly the United Kingdom, lobbied the federal government to preempt state use of worldwide combination. In response, all states that used combined reporting, including California, which was the pioneer, introduced what is known as a “water’s edge election.” A water’s edge election permits a corporation to exclude its foreign income from the combined report, meaning that it is not subject to apportionment.

It is important to be clear that the states were never trying to tax the foreign income as such; rather, the states successfully argued that the income of a unitary business should be subject to apportionment so that the MNC’s in-state income can be more accurately determined. Mandatory worldwide combination was therefore an effective tool to combat income stripping. Returning to our simple maneuver, if an MNC shifts IP to a subsidiary in a tax haven, then this does not change its tax liability. All of the income of the unitary business, including the amazingly profitable subsidiary with very few assets, would be included, as would the factors of all of the businesses that produced the income. The forced retreat to the water’s edge election

\footnote{142} Id.
\footnote{143} Id.
\footnote{145} Container Corp., 463 U.S. 159.
therefore eliminated the usefulness of combined reporting for combating stripping income from the domestic state corporate income tax base.

B. GILTI v. MANDATORY WORLDWIDE COMBINATION

There are several reasons why a return to mandatory combination appears preferable to GILTI conformity. Note that mandatory worldwide combination is an alternative to GILTI; they cannot be layered on one another. This is because GILTI chooses certain nominally foreign items of income and brings them back into the domestic tax base, but worldwide combination brings all foreign income, that labeled GILTI and otherwise, into its calculation.

There is less legal risk. I have argued at length that state conformity to GILTI should be constitutional, with the precedents upholding worldwide combination a vital piece of the argument. Of course, the argument is only by analogy; actually returning to worldwide combination is clearly even more consonant with precedent.

But is there legal risk with GILTI conformity? Yes, I think there is a little, alas. GILTI works differently than worldwide combination, and, in particular, picks out certain kinds of nominally foreign income for inclusion into the domestic base. As I have argued, there is good reason for states doing this, and this is all that the law now requires (or should require). Nevertheless, generalist judges or justices might get confused about this and accept the framing that states are picking on foreign income rather than protecting their domestic base.

Worldwide is better at combating base erosion by design. Safe and easy is all well and good, but not if it won’t work, and worldwide combination can and will work. Let’s return to our basic tax planning maneuver. An MNC might be more than willing to have its most valuable IP moved back and forth all over the world, but the MNC needs to control that IP. So long as the IP remains as part of the business, then the subsidiary, wherever it is, has to throw its income into the pot that is then apportioned.

Worldwide combination does not look to see which income was really earned where. It does not rely on an estimate of normal return (GILTI) or an imagined arms-length price between related businesses.146 Even if a state does not conform to the foreign tax credit part of GILTI, there is still the problem that GILTI only arises beyond the 10% rate and that rate itself is

146. This is the standard way of locating profits if one does not use apportionment; it is the well-known weakness of this regime that gave us GILTI.
calculated relative to the assets of CFCs. These extra moving parts give MNCs a lot to work with in terms of planning. For instance, an MNC could move real assets abroad to reduce its GILTI or shift assets among its CFCs so that the CFC housing the profits also has a higher asset base.

Worldwide combination has fewer moving parts to be manipulated. All income is included and all factors are included. Yes, the sales factor can be manipulated, but it can also be improved. And it is likely that a manipulated sales factor would do a lot better than the current regime. Consider what the sales factor would have to look like to get the kinds of results that MNCs currently get so as to place large swathes of their income in tax havens. Will the MNCs be able credibly to claim, say, that 30% of its sales were in Ireland, while 5% were in the US? For sure, an MNC will sharpen its pencils so it can claim that it has, say, a 20% sales factor in the US when a more objective few might peg the number at 25%, but that is still a big improvement over current practice.

**Worldwide is more strategic and so better combats base erosion because evasion would need to be along a different margin.** Worldwide takes full advantage of the insight that states should work on different margins than the federal government—if possible and reasonable. So, suppose an MNC has just worked very hard to reduce its federal CIT liability, how hard will it still push to reduce its state liability if much of what it did at the federal level does not help? It will surely do something, but given the much smaller amount of money involved, it is reasonable to believe the MNC will do less.

By conforming to GILTI, the states remain vulnerable to at least some of the same planning opportunities as the federal government. For instance, moving assets abroad is going to reduce GILTI both at the state and federal level. Thus, a state conforming to GILTI is further encouraging this evasive maneuver. Such a move would not affect the tax liability of an MNC as to a state that uses worldwide combination.

**VI. OBJECTIONS TO WORLDWIDE COMBINATION**

If the private bar dislikes GILTI conformity a lot (and it does), then it really, really hates worldwide combination. Here are the most common arguments against it.

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147 See discussion above as to the ultimate destination rule. For more proposals to shore up the sales factor, see Shanske, *Fiscal Capacity*, supra note 34, 487–99.
A. WORLDWIDE COMBINATION IS INCOHERENT AND UNFAIR

To understand this argument, we will use an example. Corporation X in 2018 takes a water’s edge election in California and therefore only its domestic income and sales are considered. Corporation X has $10 million in domestic income on $100 million in domestic sales. Corporation X has 10% of its sales in California, so California can apportion $1 million of its income to itself. In 2019, Corporation X must report on a worldwide combined basis. Now, it has $30 million in income on $200 million in sales, with 5% apportioned to California. California can apportion $1.5 million in income to itself. This 50% increase is attributed to the fact that, considered as a worldwide enterprise, the income of the business increased more (3x) relative to the foreign factors of the business (2x).

Taxpayers will argue—and have argued—that this is unfair, that the foreign sales were just particularly profitable and thus California is taxing more than its share. And it is true that worldwide combination is assuming that all sales are roughly as profitable. As a simplifying assumption, it clearly has something to it, as how can it be that in general some sales are superprofitable? If there are such sales, shouldn’t other competitors come in and drive down those prices? Furthermore, if there are such super sales, how are we to be sure where they are year to year and that firms are not moving them for their advantage? And we have seen plenty of evidence of super assets and the general consensus is that that evidence points to income shifting rather than to superprofitable jurisdictions.

As a matter of law, the Supreme Court, in permitting worldwide combination, has addressed such arguments against worldwide combination and found them insufficient.\(^\text{148}\) And this makes sense because, whatever its absolute strengths, worldwide combination is surely no worse than the alternatives in locating the profits of MNCs.

Still, as a policy matter, surely it is the case that not all sales of an MNC are equally profitable. But what result if one accepts this? If we are talking about small deviations that shift over time, then it should be of no great moment one way or another. Of course, we are dealing with approximations. However, if nominally foreign sales are so oddly profitable, then it seems like the worldwide method has captured excess returns. If a unitary business is generating excess returns, then, going back to our initial discussion, it is particularly efficient and appropriate for states to tax a reasonable share of these returns.

\(^\text{148}\) Container Corp., 463 U.S. at 180–84.
But worldwide combination is not targeted at excess returns. Yet worldwide combination, unlike GILTI, treats all corporate returns the same, that is, without differentiating normal from supranormal returns. If we are so concerned with supranormal returns, isn’t GILTI better? This is a cogent objection, but its strength depends on the empirical question of just how much state corporate income taxes with worldwide combination would be taxing anything other than supranormal returns. Remember that there is the trend that supranormal returns as a share of total corporate income is increasing. It is not an implausible assumption that much of the revenue gain that states would experience from a shift to mandatory worldwide combination would result from bringing shifted income back into the state corporate tax base, and it is excess returns that are most likely and most easily shifted.

Second, any GILTI-like methodology is going to add not just administrative complexity, but gaming opportunities. Even under the sophisticated approach developed by Devereux et al., a taxpayer would still have an incentive to increase its normal returns and to have those normal returns located in a low-tax jurisdiction. Thus, there is a deep question as to whether profit splits, however theoretically appropriate, are worth it in practice.

B. WORLDWIDE COMBINATION IS ADMINISTRATIVELY BURDENsome

No doubt worldwide combination does involve compliance costs, but they need not be onerous. One reason costs ought to be manageable is that taxpayers now only need to cope with one kind of factor—the sales factor. And how can it be that MNCs can’t locate their sales? Or as to income, how can an MNC not have a reasonable estimate of its worldwide income?

149. See Power & Frerick, supra note 44, at 825; see generally Fox, supra note 33.


151. This is on top of the fact that assimilating a nonroutine return according to the Devereux et al. methodology (or any methodology) with the kind of excess returns that it would be particularly efficient to tax is already to make an analytic leap. Devereux et al., supra note 84, at 22–23.


Furthermore, states typically do—and should—permit taxpayers to use reasonable methods to approximate the location of their sales. As for calculating the income of foreign subsidiaries, again, reasonableness should reign and the timing is at least somewhat propitious, as there is increased use of international accounting standards in other contexts.\textsuperscript{154} Such accounting standards could be a starting point for calculations of a CFC’s income.\textsuperscript{155}

Furthermore, the future of GILTI, as of the whole TCJA, is uncertain. If a state conforms to GILTI then it is buying into dealing with these future complexities. Both states and taxpayers know what they are getting with worldwide combinations and can adjust it at the state level as needed.

\textit{Wait, we have seen this movie before.} Back in the 1980s, worldwide combination won legal and policy battles but lost the political war. Our trading partners, particularly the United Kingdom, pressured the federal government, which in turn pressured the states, not to use mandatory worldwide combination—hence the universal availability of water’s edge elections.\textsuperscript{156} History could repeat itself, but the current context seems quite different. There is broad international consensus that base erosion and profit shifting (BEPS) are problems, so much so that the OECD has studied the issue extensively and has identified a large number of problems and solutions.\textsuperscript{157} Mandatory worldwide combination is a reasonable response to many of the problems the BEPS reports identify, such as the problem of aligning where income is reported and where value is actually created. In a world in which France has imposed a Digital Services Task,\textsuperscript{158} and other countries are considering it and at least in part in order to capture economic

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\textsuperscript{155} Note that in the context of GILTI, the private bar has been quite adamant that states must include the factors of all CFCs that generate GILTI in their calculations. To the extent that states have proposed simplifying assumptions that would mitigate the need for calculating the factors of the CFCs, there has been only rejection. If calculating the factors of the CFCs is not too burdensome when the presumed result is good for taxpayers, it should also not be too burdensome when the result is less certain.

\textsuperscript{156} See Hellerstein, supra note 15.


\textsuperscript{158} Teri Sprackland \& Stephanie Soong Johnston, \textit{French DST Signed into Law Despite U.S., Competition Concerns}, \textit{95 Tax Notes Int’l} 444, 444 (2019).
rents,\textsuperscript{159} and the United Kingdom itself has a diverted profits tax,\textsuperscript{160} the timing for a return to worldwide combination seems pretty good.

VII. ANOTHER POSSIBILITY: WORLDWIDE AND GILTI

I have argued so far that states should—and can—conform to GILTI. I have argued as well that it would be better still for states just to return to mandatory worldwide combination. I would like to conclude by evaluating a third option: giving taxpayers a choice between GILTI conformity and worldwide combination.

Because this proposal offers an election to taxpayers, it will presumably cost states money because taxpayers will choose the approach that minimizes their liability. Also, as I have just argued, worldwide combination is a better choice than conforming to GILTI and so this is another reason not to offer the choice. Yet as a matter of politics it might be too heavy a lift to return to mandatory worldwide combination; it appears hard even to conform to GILTI. I don’t claim to know exactly why this has been the case—so far—but pairing GILTI conformity with the possibility of worldwide election is responsive to two reasonable, if dramatically overstated, critiques of GILTI conformity.

The first critique complains that GILTI is poorly designed in a way that will assign too much GILTI income to innocent taxpayers. States should not exacerbate the problem, the argument goes. As explained above, I think the conceptual intuition behind GILTI is sound, and most academic observers expect GILTI to be more underinclusive than overinclusive. Still, one can imagine an MNC with very profitable foreign operations and a very small asset base, say because it provides services. Such a business might have a lot of GILTI, even if there has been no income shifting.

Now, as a matter of law, the possible over- or under-inclusiveness of a tax provision is not a substantial objection unless truly egregious, but as a matter of policy it ought to concern us—if it truly materializes. States already have an equitable remedy—known as alternative apportionment—to cope


with misfires in apportionment. This provision should be used on a case-by-case basis to address such issues.

Of course, if this is a broad enough problem, one might think this kind of discretionary approach inadequate, and here is where the worldwide election comes in. If a firm is not shifting income, but is generating substantial income abroad based on (roughly) proportional sales, then the worldwide combination method would eliminate the anomaly. Presumably, this is what a taxpayer would show the taxing authority in asking for discretionary relief, and so offering a worldwide election just formalizes that a taxpayer can use a different—and superior—methodology to apportion its income if the GILTI methodology has failed.

Offering a worldwide election also reduces the legal risk. I think GILTI conformity is constitutional. As a practical matter, the argument against GILTI relies on getting judges to accept a (false) frame in which GILTI is simply foreign income rather than a tool for better measuring domestic income. It is easier for a state to establish its framing if it offers a worldwide election because the Supreme Court has already blessed—and understood—that worldwide combination is not an attempt to tax foreign income but to measure domestic income. And so a state can say that it is offering a taxpayer two methodologies for measuring its income, and if GILTI is so terribly off then worldwide is available.

How do I know that this framing issue is helpful? Consider an important state supreme court precedent in this area, E.I. du Pont de Nemours and Co. v. State Tax Assessor. The facts were roughly as follows. Maine offered MNCs, like the taxpayer, a water’s edge election. Therefore, Maine did not include the income or factors of its foreign subsidiaries in its calculation of CIT. However, when the foreign subsidiaries did send back dividends, these dividends were included in the Maine tax base. Earlier taxpayers had argued that it was not constitutional for the state to include the income of foreign subsidiaries without including their underlying factors. And yet, I presume, the state was not at all sure that bringing in all the foreign factors would yield an appropriate answer as to domestic income if some of the income coming back from foreign subsidiaries was not really earned there. In other words, the situation is highly analogous to the situation with GILTI. The solution Maine arrived at was to use the worldwide method as a check.

164. See E.I. Du Pont, 675 A.2d at 84.
If a taxpayer’s tax liability is truly greater under the regime of just including foreign source dividends without factor representation, then the taxpayer would use the worldwide combination result. This is known as the “Augusta Formula” and this is a good option for states looking for a middle way in opting for GILTI conformity. Note the Augusta Formula would not be an election but requires taxpayers to go through the alternative calculations.

With the Augusta Formula or an election, there is not an unconstitutional conditions problem here because GILTI conformity is itself constitutional. The proposal to pair GILTI and worldwide is not to make GILTI constitutional when it otherwise would not be, but rather to make clear to a generalist judge that conforming to GILTI was always constitutional because conforming to GILTI is a means to better measure domestic income.

But how hard would it be to add such an election as a matter of politics? Here there is good news. Many states added water’s edge elections when they retreated from worldwide combination. Thus, taxpayers already have this option. Thus, all such states need to do is conform to GILTI and the taxpayer has the election. It is a little like Dorothy realizing she could go home all along.

CONCLUSION

To return to the beginning, states looking to revamp their revenue structure should ideally not start with their corporate income taxes. That said, there is more potential to tax corporate income than is generally understood and, in response to the current crises, states should not be leaving billions of dollars in their couch cushions.

States find themselves in a strong position to tax corporate income for many reasons, but the primary reasons are that the states have developed a means of dividing up the income of a multijurisdictional enterprise that is different from how the federal government does it. Both systems are reasonable, if flawed, but the fact that they are different means that taxpayers cannot in many cases reduce both taxes by making the same planning choices. Further, because the state levy is at a lower rate, this suggests that many taxpayers will pay the state-level tax without too many additional contortions to evade it. Finally, there is good reason to believe the state approach is more rigorous and will therefore be harder to evade.

165. Id.