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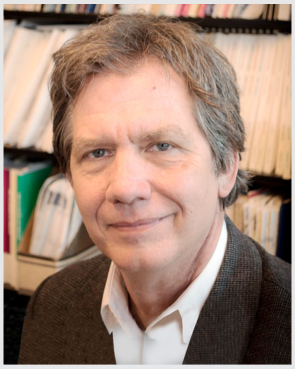

Bruce J. Fort

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In this article, Fort explores how several states came to include an obscure provision in their laws that has enabled multinational corporations to significantly reduce or eliminate their state tax liabilities.

The opinions expressed in this article are the author's alone and do not necessarily represent those of the MTC or its member states

Introduction

At long last, mandatory combined reporting for domestic corporations has become the majority rule in the states, significantly reducing the ability of taxpayers to understate income, while simultaneously reducing litigation costs and compliance burdens. But establishing an effective regime for taxation of corporate net profits is a complicated matter, requiring an understanding of its unique context — formulary apportionment — with simultaneous attention to the smallest details in how the tax base is determined. Nowhere is this more important than in implementation of mandatory combined filing.

This is the story of how several states, in transitioning from worldwide combined reporting (WWCR) to water's-edge combined reporting some 30 years ago, came to include an obscure provision in their laws that has enabled some multinational corporations to significantly reduce or eliminate their tax liabilities in those states. The provision is an exception to the definition of the water's-edge combined filing group for so-called domestic 80/20 companies. A domestic 80/20 company is typically described as a U.S. corporation having 80 percent or more of its payroll and property located overseas; other states describe the excluded 80/20 companies as U.S. corporations having less than 20 percent domestic factors.[1]

Domestic 80/20 companies create an opportunity for income sheltering because the companies are excluded from the states' water's-edge return, yet they are included in the federal consolidated filing regime. As explained in some detail below, the federal tax code encourages transfers of assets between related domestic corporations. The states' conformity to this policy sets the stage for nonrecognition transfers of assets to domestic 80/20 companies, without triggering the federal tax obligations that would arise from a transfer to a true foreign subsidiary. Surprisingly, the 80/20 exclusion is not just a puzzling relic of the past; it remains in the laws of 16 states, including some that have adopted water's-edge filing regimes in the past decade. Twelve of those states[2] define these companies by referencing the percentages of domestic property and payroll as determined under the Uniform Division of Income for Tax Purposes Act

[1] The seemingly inconsequential choice of how to express the same fractional test can lead to quite different outcomes, providing an early hint as to the arbitrary nature of the exclusion.

[2] Arizona, Ariz. Rev. Stat. section 43-1101(5)(b); Colorado, Colo. Rev. Stat. section 39-22-303(8); Connecticut, Conn. Gen. Stat. section 12-218f(b)(1); District of Columbia, D.C. Mun. Regs tit. 9 section 157.3; Illinois, 35 ILCS 5/1501(a)(27)(A); Indiana, Ind. Code section 6-3-2-2.4(b); Kentucky, Ky. Rev. Stat. section 141.202(8)(a); Montana, Mont. Code Ann. section 15-31-222(a); New Hampshire, N.H. Rev. Stat. Ann. section 77-A:1.XV; New Mexico, N.M. Stat. Ann. 1978, section 7-2A-2(BB); North Dakota, N.D. Cent. Code section 57-38.4-01(7)(a); Texas, Tax Code, section 171.1014; Vermont, Vt. Admin. Reg. section 1.5862(D).

sourcing rules.[3] The other four[4] reference the percentage of the entity's income meeting the "active foreign business income" test of former IRC section 861(c)(1).[5]

The ubiquity of the 80/20 company exclusion in combined filing states might suggest that it was intended to serve some important purpose. No such inference should be drawn, however. The 80/20 exclusion was touted as a solution to a problem that never existed: the alleged difficulty that U.S. corporations had in converting their foreign earnings to U.S. currency amounts for tax and accounting purposes. In keeping with that historic justification for their creation, domestic 80/20 companies are sometimes referred to as foreign operating companies (FOCs). It is a misleading label though, because they are not foreign, and frequently, they are not operating companies.

A case decided recently by the Illinois Independent Tax Tribunal illustrates just how easily 80/20 companies can be used to shelter domestic income.[6] In 2010 PepsiCo Inc. undertook a restructuring of its domestic and foreign operations after it acquired several previously independent foreign soft drink bottlers. PepsiCo then created Frito-Lay North America Inc. (FLNA), structured to be a domestic 80/20 company. But it did not transfer its recently acquired *foreign* operations to that newly created entity. Instead, it transferred a handful of managerial employees and the intangible property rights of its *domestic* snack foods business to FLNA.[7] Meanwhile, about 160 overseas employees of other PepsiCo subsidiaries *may* have learned they were now the employees of a shell company called PGM LLC — a disregarded entity of FLNA.[8]

Despite generating 97 percent of its revenues from domestic sales, in theory at least FLNA met the definition of an 80/20 company under Illinois's laws, allowing PepsiCo to eliminate about $2.5 billion in net income annually from the water's-edge return. Before the tax tribunal, PepsiCo argued that the state was bound by the terms of the 80/20 statute and could not challenge the economic substance of the transactions, including the status of those 160 PGM employees. The tribunal held otherwise, but the facts in the next case may not present such a compelling argument for application of the economic substance doctrine.[9]

The good news is that the domestic 80/20 loophole can easily be fixed, without affecting the remainder of the water's-edge combined filing regime, if legislatures have the will. Minnesota removed its 80/20 exception in 2013, after that state's highest court declined to recognize the taxing authority's common law ability to disregard the tax effects of what was clearly a sham transaction.[10] And there is a bill pending before the Vermont legislature to remove that state's 80/20 company exception to the definition of the water's-edge return.[11] But the states should consider going beyond just canceling this particular zombie provision, and take the opportunity to revamp and modernize their combined reporting statutes.

Enter the Multistate Tax Commission. The MTC developed a model combined filing statute in 2006 based on the so-called *Joyce* approach for apportioning group income. The MTC's Uniformity Committee has recently completed its work on an alternative model, based on the

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[3] The Uniform Division of Income for Tax Purposes Act. 7A *Uniform Laws Annotated* 152 (2002); and *RIA All States Tax Guide*, para. 701 et seq. (2005).

[4] Alaska, Alaska Stat. section 43.20.145(a)(1)(A); North Carolina, N.C. Gen. Stat. section 105-130.5A(j); Michigan, Mich. Comp. Laws section 206.607(3); Wisconsin, Wis. Admin. Code Tax section 2.61(2)(B).

[5] The definition of a foreign operating company in IRC section 861(c)(1) was eliminated in 2010. Although describing 80/20 companies by referencing the former test should provide some assurance that a company does not function simply as a holding company for intangible property, the carveout is still problematic, because it leads to a misalignment of domestic income and expenses.

[6] *PepsiCo Inc. and Affiliates v. Illinois Department of Revenue*, Nos. 16 TT 82 and 17 TT 16 (Ill. Tax Trib. Apr. 13, 2021).

[7] FLNA then contracted with its sister corporation, Frito-Lay Inc., to manufacture Cheetos and other well-known snack items. *Decision* at 4.

[8] PepsiCo neglected to update its International Assignment Handbook to reference PGM as the employer of record, nor did PGM have any ability to hire, supervise, or terminate employees. *PepsiCo* at 22.

[9] The state tax tribunal had earlier rejected IBM Corp.'s similar arguments that the state lacked the ability to challenge the economic substance of its 80/20 company. *International Business Machines v. Illinois Department of Revenue*, 14 TT 229 (Dkt. No. 5 2015).

[10] *HMN Financial Inc. v. Commissioner of Revenue*, 782 N.W.2d 588 (Minn. 2010); Minn. Stat. 290.17, subd. 4(f)(h), as amended by, Minn. Laws 2013, C. 143, Art. 6, section 34.

[11] H. 189.

Finnigan income apportionment method.[12] This alternative has been approved by the member states in a recent survey, meaning that it can now be considered for adoption by the MTC. Both models were developed after considerable research, drafting efforts, and consultation with our member states. The models provide the foundations for a workable, consistent, and fair means for apportioning and allocating the domestic income of multijurisdictional taxpayers.

Both model statutes define the water's-edge tax base to include all U.S. corporations subject to income tax.[13] Both models provide the tax administrator with some discretionary authority to include or exclude entities when appropriate to prevent distortions of income. These provisions are critical to ensuring that a state's combined filing regime will fairly apportion the income generated in the states.

The MTC's uniformity projects now include additional explanatory materials, including drafter's notes, hearing officer's reports, white papers, and extensive recordkeeping of the (always public) deliberative processes to explain why particular choices were made. The MTC has a mandate to promote uniformity of tax laws, ensure accurate determinations of tax liability, and ease of administration and compliance for multistate businesses. The best tool for achieving these goals are model laws, but they only work if states incorporate their relevant provisions into their own laws.

Now back to domestic 80/20 companies. The section below titled "How State Income Shifting Works" has a more detailed explanation of how these companies are used to shelter income from state taxation, but it is pretty simple. You may also be interested in how a provision lacking any economic, tax, or policy justification got to be included in the combined filing statutes of 16 states or in reading about the few cases in the public record that provide some hints of the states' revenue losses.[14]

Prologue: This Must Be the Place

Picture, if you will, the view from a subleased office space in a modern skyscraper in the city of George Town, Grand Cayman Island, on the morning of May 10, 2010.[15] The beach below you is sparkling white, while the gentle sun casts the waters of the harbor in shades of azure and turquoise. Behind you, there may be filing cabinets, or perhaps just a laptop, containing mortgage instruments originally valued at $153 million belonging to Home Federal REIT Inc., which is itself a wholly owned subsidiary of Federal Home Savings Bank. The bank lends money to Minnesota customers, but the mortgage payments from those customers do not go back to the bank. Instead, they make their way to the real estate investment trust, a passthrough entity not subject to state or federal income tax.

The REIT is a passthrough entity[16] paying taxable dividends to its owner, HF Holdings Inc., a U.S. corporation authorized to do business in the Cayman Islands (although it is unclear what business is being done there). The considerable income of HF Holdings is included on the U.S. consolidated tax return of Federal Home Savings Bank, but because of Minnesota's domestic 80/20 exclusion, that income is not included on its Minnesota water's-edge

[12] Under the *Finnigan* method, the filing group is treated as a single entity for purposes of apportionment, resulting in a single in-state numerator and single denominator for the entire group. Under the *Joyce* method, the entire group's sales are included in the denominator, but only the sales of entities subject to tax in the state are included in the numerator. For a more complete examination of the two models, please visit the MTC's uniformity website. The author served as the hearing officer for the MTC's *Finnigan*-based model.

[13] Both models call for inclusion of foreign entities with an average of 20 percent domestic property, payroll, and sales when engaged in a unitary business with their domestic counterparts. These entities would be subject to federal tax on their U.S.-source income.

[14] Readers looking for formal estimates of revenue losses occasioned by the 80/20 carveout will be disappointed, because no comprehensive studies were located. Yet the few cases addressing the 80/20 company exclusion discussed here that are of public record suggest the losses may be substantial.

[15] The essential facts in this narrative are taken from the opinion of the Minnesota Supreme Court in *HMN Financial*, 782 N.W.2d 558 (Mn. 2010). I have taken some artistic license here — I don't know, for instance, the exact location of the subleased office space on the island, or if it had a nice ocean view. I hope it did.

[16] Assuming the REIT wanted to avoid any entity-level federal tax, it would have been required to pay 90 percent of its annual earnings in the form of a taxable dividend to its shareholder, HF Holdings, allowing it to claim a dividends-paid deduction. *See* IRC section 857.

combined return. The state would face an uphill battle asserting nexus to tax HF Holdings on a separate company basis.[17]

May 10, 2010, is a particularly good day to be you — the only employee of HF Holdings — because today the Minnesota Supreme Court has concluded that there is absolutely nothing the state's Department of Revenue can do to challenge the income shift to HF Holdings, because it meets the literal definition of an 80/20 company. Its only payroll (your salary) is sourced to the Cayman Islands, and the corporation's only property, the subleased office space, is sourced there too.

As you sit in your beautiful office, looking forward to another year in paradise, you may ask yourself, "Well, how did I get here?" To answer that, we must go back further in tax history, to the year 1983.

The Worldwide Unitary Taxation Working Group, Part I

The date is June 27, 1983. At the opening of the Supreme Court's sitting on this sweltering day in Washington, D.C., Justice William J. Brennan Jr. reads a summary of the Court's decision in *Container Corp*.[18] It is the most important state income tax case in a generation and everyone in the state tax world knows it.[19] In a sweeping 36-page decision, the Court upholds California's use of WWCR as a valid means of measuring the in-state income of multinational business enterprises. Several states have followed California's lead, although few have enacted comprehensive WWCR statutes.

The Court rejects the taxpayer's claims that formulary apportionment applied on a worldwide basis violates the dormant foreign commerce clause by preventing the United States from "speaking with one voice" on foreign affairs, noting that legislation to preclude WWCR had failed in Congress. The Court concludes that any duplicative taxation that might result from California's use of WWCR is an insufficient reason to strike down the taxing method, when it is both internally and externally consistent.

Container Corp. provoked deep concern in the business community and at Treasury, triggering calls for congressional preemption of the states' use of formulary apportionment entirely. Arm's-length accounting was the bedrock principle of income division for international tax purposes, even though the Government Accountability Office had concluded two years before it was not working well, especially when intangible property values were transferred in isolation or in conjunction with goods and services.[20] WWCR, especially if it spread to other countries, was seen as a threat to those settled expectations.[21] Shortly after the decision was announced, U.K. Prime Minister Margaret Thatcher penned her famous letter to President Reagan, urging federal intervention to protect British business and financial interests from the burdens imposed by the states' use of WWCR and formulary apportionment. The letter ended with a politely worded threat of retaliatory action if the states continued the practice.[22]

What happened next seems almost inconceivable today — if for no other reason than the level of attention that was focused on state corporate taxation by the federal government, the states, and the business community. Rejecting calls to support a motion for reconsideration of *Container Corp.*, Treasury

[17] One state has been successful in asserting income tax nexus against a holding company receiving taxable dividends from a captive REIT operating within the state. *Bridges v. AutoZone Properties Inc.*, 900 So.2d 784 (La. 2005). Minnesota's water's-edge statute called for inclusion of 20 percent of any dividends paid by the 80/20 company in the water's-edge return, but income can effectively be transferred between domestic entities without dividend payments.

[18] *Container Corp. of America v. Franchise Tax Board*, 483 U.S. 169 (1983).

[19] You can listen to the argument here: Oyez.com, *Container Corp. of America v. Franchise Tax Board* (Jan. 10, 1983).

[20] GAO/GGD-81-81, "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations, Report to the Chairman of the House Ways and Means Committee" (Sept. 30, 1981), discussed in Jerome R. Hellerstein, *State Taxation*, para. 8.10[7][a], fn. 269, 270 (1983). *See also* GAO-GGD 92-89 (June 1992).

[21] The international tax community may yet adopt some principles of formulary apportionment and combined reporting. *See generally* Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (2006).

[22] Letter from Prime Minister Margaret Thatcher to President Ronald Reagan (Aug. 30, 1983). The letter is appended to a 2018 amicus brief submitted by David Gamage, Hayes Holderness, and Darien Shanske, in the appeal of *Department of Revenue of Colorado v. Agilent Technologies Inc.*, Colo. S. Ct. No. 217-SC-840. The brief richly details the political pressures exerted on the states to abandon WWCR.

created a Worldwide Unitary Taxation Working Group in September 1983 to see if the dispute between the states and the business community could be resolved without federal preemption. The working group was composed of high-ranking representatives of the U.S. government, the CEOs of some of the world's largest corporations, and state officials, including the governors of California, Illinois, and Utah, and representatives from the MTC and Federation of Tax Administrators.[23]

In a series of 20 meetings held from November 1983 to May 1984, the working group reached an agreement that called for the states to voluntarily move to a water's-edge combined filing system that would exclude most foreign corporations from the combined report. The working group could not, however, come to agreement on two additional proposals from the business community: (1) that states exclude foreign-source dividends from the tax base, and (2) that states exclude "U.S. Corporations with 80 percent or more of their property and payroll factors located overseas" from the water's-edge filing group.[24]

Because of the lack of agreement on those two matters, the working group ended its efforts in the summer of 1984 without producing a single proposal for the states' consideration. Instead, the working group identified six different options, three from the states and three from the business community. Two of the three state proposals would have included foreign dividends and domestic 80/20 companies in the water's-edge tax base. All three of the proposals from the business community called for the exclusion of those items.[25]

The working group's consideration of 80/20 companies is central to this story, but to put the debate into context, we must briefly touch on the differences between the state and federal corporate income tax systems. That discussion will illuminate the mechanism underlying so many state income-shifting efforts, including income shifting to domestic 80/20 companies.

The State and Federal System, Compared

The Federal Tax Base and Consolidated Filing System

Broadly speaking, the IRC uses a residency-based system of taxation for U.S. corporations, taxing their worldwide income, while relying on a generous credit system for foreign taxes paid to eliminate the potential for double taxation by countries taxing the same income on a source basis. The earnings of foreign subsidiaries — known as controlled foreign corporations — are not subject to tax, although the domestic owners of the CFCs were taxed (before enactment of the Tax Cuts and Jobs Act) if the income was repatriated in the form of dividends. Because a CFC's income is generally outside the federal tax base, the IRC includes two important provisions, section 367(d) and section 482, to prevent income shifting to them. Section 367(d) requires a domestic corporation that transfers income-producing intangible property to its overseas subsidiaries to recognize a deemed royalty amount. Section 482 provides the mechanism for ensuring that the royalty imposed on the domestic transferor is fairly calculated to reflect the expected profits flowing to the CFC from that transfer. It provides in part that: "In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

Nothing like IRC section 367(d) applies in the context of a transfer of intangible property among related domestic (U.S.) corporations, because those corporations will all be subject to federal tax, and the related corporations will almost certainly be filing a federal consolidated return

[23] U.S. Treasury, "The Chairman's Report on the Worldwide Unitary Taxation Working Group," 17-19 (July 1984); and "Final Report of the Worldwide Unitary Taxation Working Group" (Aug. 1984).

[24] Final Report, Letter of Treasury Secretary Regan to President Reagan, p. ii. (Aug. 31, 1984). Secretary Regan endorsed the working group's recommendation that the federal government assist the states by providing training on transfer pricing adjustments, increased IRS auditing of international transfer pricing, and federal legislation that would have required disclosure of interstate apportionment calculations. Final Report, at 9.

[25] *Id.* at 27-58. The states' first proposed option would retain worldwide combined reporting for multinational businesses with domestic parents, while allowing foreign-controlled unitary corporations to pay an alternative activities tax based on the comparable profits of similar industries.

under sections 1501-1505. Assets can be transferred to a newly formed and controlled entity under section 351 without recognition of income — a policy intended to further the efficient use of capital.[26] And any dividends paid by the transferee are subject to a deduction under IRC section 243 (or elimination on the federal consolidated return) to eliminate double taxation.

The State Tax Base and Water's-Edge Combined Filing System

The states typically use federal taxable income as the starting point of their own income calculations, including the domestic dividend treatment described above. The states are not empowered to tax income generated beyond their borders, of course. Rather than relying on geographic accounting to calculate in-state earnings, states use the system of formulary apportionment proscribed in UDITPA. Critically, the measure of property under UDITPA is limited to real and tangible personal property. Intangible property values were assumed, with considerable justification,[27] to be inseparable from the factors used to measure where a business operated and thus generated income — including the business's markets.[28] For the same reason, UDITPA does not include clear guidance on sourcing income arising out of the sale of or licensing of intangible property. Neither the cost of performance nor income-producing activity concepts in UDITPA's section 17 apply easily to that kind of income stream. The states are rapidly moving to fix the problem with the adoption of market-based sourcing.

Separate-entity states use formulary apportionment to measure the in-state earnings of corporations with nexus in the state, while relying on arm's-length accounting principles in calculating the income of filers that have intercompany transactions with affiliated entities or that have foreign income.[29] Water's-edge combined reporting largely incorporates the federal consolidated tax base, allowing the states to take advantage of federal income calculations done on a consolidated basis and to rely on IRS audits to a greater extent than would be possible under separate-entity reporting. Water's-edge reporting also allows the states to rely on IRC section 367(d) and section 482, and federal enforcement of those provisions, to limit the erosion of the domestic tax base arising from transfers to CFCs.

But all water's-edge states typically provide for at least some exceptions to the conformity with the federal tax base, the two most common being the exclusion of insurance companies (at least to the extent they are subject to the state's premiums tax) and the exclusion of domestic 80/20 companies. Both these exceptions create similar opportunities to game the system.[30]

How State Income Shifting Works

Until recently, most state income-shifting tax schemes worked in pretty much the same way.[31] The mechanism by which the shift is accomplished has been obvious and well known for decades and may already be clear to you after reading the descriptions of the two systems above. For some reason, however, the method by which income shifting occurs is rarely discussed, even in those cases addressing the application of the states' remedial authority to reallocate income and expenses to fairly reflect income generated in the state.[32] The nonrecognition of income for domestic transfers of intangible property under

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[26] Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 3.01 (2000).

[27] *See Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 223-224 (1897) (A company's intangible value is "distributed wherever its tangible property is located and its work is done."); *see also A&F Trademarks Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004).

[28] *See, e.g., Pacific Coca-Cola Bottling Co. v. Department of Revenue*, 10 OTR 535 (Or. T.C. 1987), *aff'd*, 307 Or. 667, 773 P.2d 1290 (1989) (rejecting the taxpayer's petition for use of a fourth "intangible property" factor, reasoning that the intangible property values were already reflected in the price of syrup sold to bottlers).

[29] There is, predictably, little federal auditing of domestic intercompany transactions.

[30] Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para. 9.20[8][j] (2001). Establishing a captive insurance company requires considerably more effort, but once established, the process by which income is shifted is essentially identical.

[31] The discussion of more modern income-shifting techniques must wait for another day. In brief, shifting intangible values out of the taxing states' jurisdiction has become far more sophisticated and more subtle. The new methods were in part a response to the enactment of addback statutes by many states in the early 2000s that denied deductions for intercompany royalty payments.

[32] *See, e.g., Utah State Tax Commission v. See's Candies Inc.*, 435 P.3d 147 (Utah 2018); *but see In re InterAudi Bank, F/K/A Bank Audi (USA)*, DTA No. 821659 (N.Y. Tax App. Apr. 4, 2011).

IRC section 351 is the key to these income-shifting strategies.

The states follow section 351's nonrecognition treatment for domestic transfers between related parties through conformity to the federal code. As a result of that conformity, a transfer of intangible property to a domestic corporation that is excluded from the states' combined filing group, for example, a domestic 80/20 company, will not trigger a royalty payment under section 367(d), because that provision applies only to transfers to true foreign subsidiaries. And under IRC section 243, any income arising from licensing the intangible property can be returned as a deductible domestic dividend, or as an intercompany loan, also without any tax consequences. The income has, for state tax purposes, simply disappeared.

The most common types of intangible property used in setting up income-shifting strategies are trademarks and trade names, said to represent a business's goodwill value.[33] A transfer pricing report is usually prepared estimating the value of the transferor's ongoing business over and above the value of its tangible assets, which is then used to establish a hypothetical royalty payment amount for the use of those trade names and trademarks. Goodwill values can be estimated as an accounting exercise, but whether those values can truly be separated from an ongoing business is another matter.[34]

Upon completion of the transfer pricing report — and sometimes even before the report is completed — a licensing agreement is entered into by which the transferor of the trademarks and trade names agrees to pay the transferee (such as an excluded 80/20 company or captive insurance company) a royalty for the use of the property the transferor bestowed on the transferee in a nonrecognition transaction just moments before. The royalty income can then simply be returned to the transferor in the form of deductible domestic dividends.

[33]*See, e.g.*, *Visa U.S.A. Inc. v. Birmingham Trust National Bank*, 696 F.2d 1371, 1375 (Fed. Cir. 1982).

[34]*See Adams Express*, *supra* note 27.

Note the irony here: The domestic transfer/license-back transaction has turned the purpose of sections 367(d) and 482 on its head. Rather than establishing a royalty amount that will be recognized as taxable *income* to the transferor under those sections, the transfer pricing report is used to establish how much of a *deduction* from income the transferor can claim.[35]

Doubtful it can be that easy? If so, consider a recent case from Colorado concerning Target Corp.'s 80/20 company, Target Brands Inc. (TBI), and decide for yourself.

What Would Mary Richards Do?

In January 2017 a Colorado district court rendered its findings of fact and conclusions of law in *Target Brands Inc.*, offering the public a rare glimpse into how 80/20 companies are used to shift income outside the water's-edge return.[36] The story begins in 1998, when Target Corp., "with the assistance of outside counsel and accounting firm Ernst & Young, . . . developed the concept of an IP holding company. That was the genesis of TBI."[37] The court's findings continued:

> Target believed that because TBI had a U.S. presence only in Minnesota neither its assets nor its royalty income would be subject to tax in certain states. Second, Target believed the tax savings would be increased if at least 80 percent of TBI's payroll and property were located outside of the United States.[38]

[35]State remedial provision patterned after IRC section 482 may nonetheless be invoked to prevent such income-shifting efforts. Treas. reg. section 1.482-1(f)(1)(iii)(A) provides that: "if necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as 351 or 1031)." *See also* Swain, "IRC Section 482: It's Not Just About Transfer Pricing," *State Tax Notes*, Oct. 9, 2017, p. 149.

[36]*Target Brands Inc. v. Department of Revenue*, No. 2015CV33831 (Denver Dist. Ct., filed Jan. 27, 2017).

[37]*Id.* at Finding of Fact No. 11.

[38]*Id.* at Finding of Fact No. 13. Although Minnesota could have asserted nexus over TBI, as Colorado later did, it is unclear how much, if any, of its income would have apportioned to the state under Minnesota's apportionment rules. We can assume that at least 80 percent of TBI's limited property and payroll would have been sourced to foreign locations. And the taxpayer could have argued that its greatest cost of performance for trademark protection occurred overseas as well. *See* UDITPA section 17.

The court's description of the sale/leaseback transaction and the subsequent return of the royalty income to Target as nontaxed loans and dividends should sound familiar:

> 18. Shortly after TBI's incorporation, Target and TBI executed a number of agreements: a Contribution Agreement, a License Agreement, a Revolving Note, and a Tax Sharing Agreement. [Citations to the record here and in subsequent paragraphs have been omitted.]
>
> 19. Under the Contribution Agreement,[39] Target contributed to TBI its then-existing intellectual property assets, which are listed on Schedule A to the Contribution Agreement.
>
> 20. TBI and Target also entered into a License Agreement on the same date. Under the License Agreement, TBI granted Target the right to use its IP in connection with Target's sale of products in its retail operations. TBI also granted Target the exclusive right to use TBI's then-owned IP and any future IP in connection with the sale of Target's products nationwide.
>
> 22. Additionally, the License Agreement provided:
>
>> a. In exchange for the right to use the IP, Target agreed to pay TBI monthly "Percentage Royalty Payments" equal to the sum of a royalty rate multiplied by 7 "Target Net Sales."
>>
>> c. The Target Royalty Rate for the initial license year was 3 percent of Target's net sales.
>>
>> d. The goodwill of the IP belonged exclusively to TBI.
>
> 39. Under the Revolving Note, TBI loaned its available cash assets to Target on a daily basis and Target paid TBI interest on the loaned amounts.
>
> 75. Prior to the creation of TBI, Associated Merchandising Corporation ("AMC") provided product-sourcing services to Target. Upon formation of TBI, the AMC employees who had been engaged in regional sourcing for Target-owned brands became TBI employees as part of the corporate restructuring.
>
> 77. Ms. Street testified that AMC employees were hired because TBI needed sufficient foreign employees to be considered an "80/20" company (a status that could result in preferential tax treatment) and because of the employee's experience.
>
> 99. Pursuant to the License Agreement, Target paid TBI royalties in the amount of $17.9 billion between February 1999 and January 2010.
>
> 105. Despite substantial royalty payments, Target's net cash flow remained largely unchanged. TBI immediately returned virtually all of the royalty payments in the form of loans under the Revolving Note or dividend payments to Target as TBI's sole shareholder.
>
> 115. Had TBI been included in Target's combined return, the amount of Target's income subject to apportionment [in 2002] would have been $1,079,549,142 instead of negative $255,172,145.
>
> 117. After applying Colorado's corporate income tax rate, Target would have owed $1,132,267.74 to Colorado. (*See id.* ($24,455,026.71 x 4.63% = $1,132,267.74). Instead, Target paid no income taxes for tax year 2002. (*Id.*) Thus, for only one tax year, Target saved $1,132,267.74 by excluding TBI from Target's combined Colorado income tax return.

While TBI meets Colorado's statutory requirements for being an excluded 80/20 company, Colorado contended that TBI's

[39] The IRC section 351 transfer of intangible property.

trademark and royalty receipts derived from Target's stores offered a sufficient basis to assess TBI on a separate-entity basis.[40] The district court ultimately agreed, but the court concluded that the state was required to apply a three-factor apportionment formula to TBI's royalty income, because its overseas property and payroll were more than de minimis. While the overseas property and payroll factors were real, the economic activity they represented paled in comparison with the almost $18 billion in royalties TBI pulled out of Target's income tax base. The original assessment amount (based on using TBI's sales factor alone) was thus reduced by approximately two-thirds,[41] allowing both parties to claim a partial victory.

Careful readers may note the absence of any factual findings related to the nontax business purposes for the transactions shifting income to TBI. TBI's first president was described as one of Target's lawyers with "experience in the management and protection of IP, as well as in state tax focusing on the nexus between Target and the various states."[42] That witness and others described all the nontax business reasons for creating TBI and then paying it almost $18 billion in royalties. There is nothing to be gained from challenging those findings. The 80/20 carveout is the problem. The resulting understatement of in-state earnings is not lessened simply because the transactions have a plausible nontax business purpose.

Just down the street from Target's headquarters on Nicollet Mall in Minneapolis is the iconic statue of Mary Tyler Moore, who played the role of Mary Richards in a pioneering television show set in the city. Moore's character was arguably the least judgmental person on the planet. But what would the fictional Mary Richards have made of the events of 1998 taking place a few blocks away, when Target's executives gave the green light to TBI's creation? Those executives surely felt compelled to do whatever was legally permissible to keep up with their competitors, who were also keenly aware of the 80/20 company loophole. A whole cottage industry devoted to creating plausible business purposes for similar transactions has evolved as a consequence. There simply must be a better way forward for our profession.

As demonstrated in *Target*, the confluence of state conformity to IRC section 351 nonrecognition treatment when paired with the domestic 80/20 carveout results in a gap in the states' taxing systems wide enough for a catamaran to sail through. All that is needed, as a matter of strict statutory construction, is a single employee and a filing cabinet located overseas. Since UDITPA's property definition is limited to real and tangible property, the 80/20 company's ownership of intangible property like mortgage derivatives, or the goodwill associated with the name "Target," simply does not enter into the equation.

And that is how you came to be working for HF Holdings — or something just like it — in an office overlooking the sparkling waters of Grand Cayman Island. Congratulations.

The Worldwide Unitary Taxation Working Group, Part II

Now that we are armed with an understanding of how state tax income-shifting strategies work, it is time to return to the Cash Room at Treasury in early 1984. The discussion is whether companies with substantial foreign operations should be excluded from the state combined filing system. Business community representatives argue that these companies should not be in the water's-edge combined return for the reasons they allege that WWCR might be injurious to international trade and commerce. Yet most of the criticisms of WWCR have already been rejected by the Court in *Container Corp*. Most importantly, the Court rejected the idea that WWCR leads to an overstatement of domestic income. What's left is a notion that the imposition of additional compliance burdens on foreign operations — used as they are to arm's-length accounting and

[40] One of the three audits at issue for the audit period from tax year 1999 to 2009 was conducted through the MTC's Joint Audit Program. Additionally, an audit supervisor employed by the MTC testified in the case.

[41] Using Target Corp.'s in-state apportionment percentages would have better reflected TBI's business presence in the state, as other courts have concluded in similar circumstances. *See, e.g.*, *Gore Enterprise Holdings Inc. v. Comptroller of Maryland*, 87 A.3d 1263 (Md. 2014); and *In the Matter of Wal-Mart Stores Inc.*, Decision & Order No. 06-07 (N.M. Tax and Rev. Dept. May 1, 2006).

[42] *Target Brands* at Finding of Fact No. 9.

keeping their books and records in a foreign currency under foreign rules — violates the dormant foreign commerce clause.[43] But none of those foreign commerce clause concerns apply to U.S. corporations, which would be subject to U.S. tax and regulatory reporting. So, businesses argue that since domestic 80/20 companies would mostly be operating overseas, they should be treated as foreign corporations in keeping with the spirit of the states' agreement to move to water's-edge reporting.

In 1984 there was a federal conception of an FOC, also known as an 80/20, but it is a far different animal than the factor-based 80/20 company being proposed. The definition of an FOC embodied in what was then section 861(c) was a U.S. corporation that derives at least 80 percent of its income from the conduct of an active business overseas.[44] IRC sections 862 and 863 describe how to segregate domestic and foreign income sources in making the 80 percent foreign income calculation. An eligible FOC could claim credits for foreign taxes paid and received other considerations, such as not having to withhold tax on interest and royalties paid to foreign persons, but importantly, the income of the FOC remains in the federal consolidated tax base.

The business representatives insist that instead of using the federal definition found in section 861(c), this new concept of an 80/20 company must be based on relative percentages of property and payroll as defined under UDITPA. The state representatives smell a rat, metaphorically speaking. This new type of entity could be used to shift domestic income out of the tax base, they warn.[45] Oh no, the industry representatives counter, nothing could be further from the truth. They argue:

> The proposed foreign business activities test is both substantial (80 percent) and substantive (payroll and property). This will guard against the use of "shell" or "paper" corporations to avoid state taxes and prevent those not having primarily foreign operations from being excluded from the states' tax base.
>
> Merely because an 80/20 company is included in a federal tax return is no reason to consider it inside the water's edge.
>
> The test of an 80/20 corporation depends on the location of property and payroll. A corporation that satisfies the payroll and property threshold would also generally satisfy the federal definition. Thus these U.S. corporations . . . would be subject to extensive federal audit.[46]

We simply must assume that the business representatives were acting in good faith and did not envision that their proposed new 80/20 creations would be exploited for tax reduction purposes. But if there was a reason for insisting on an easily manipulated property and payroll test rather than using the well-defined "source of income" test, it did not make it into the final or supplemental reports.

The States Keep Their End of the Bargain

Following the working group's final and supplemental reports, the states "acted with unusual legislative speed"[47] in moving from WWCR to water's-edge reporting. It should be apparent from this brief history that the states' conversion to water's-edge filing was not entirely voluntary — in 1985 two preemption bills were introduced in Congress with the administration's backing to force the issue.[48]

Oregon's adoption of water's-edge reporting in 1984 was followed closely by similar enactments in Colorado, Arizona, Idaho, Indiana, Montana, New Hampshire, North Dakota, and Utah in 1985. California adopted a water's-edge combined reporting option in 1986, followed by Minnesota in 1987. While these early statutory provisions bear some similarities, the states particularly diverged in their treatment of foreign

[43] That argument would be rejected nine years later in *Barclays Bank PLC. v. Franchise Tax Board*, 512 U.S. 298 (1994).

[44] The federal 80/20 regime was effectively eliminated in 2010 by P.L. 111-226.

[45] Final Report, *supra* note 23, at 14-15.

[46] *Id.* at 15-16.

[47] Hellerstein, Hellerstein, and Swain, *supra* note 30, at para. 8.18 (2016).

[48] Unitary Tax Repealer Act, S. 1974, 99th Cong., 1st Sess. (1985); and the Unitary Tax Bill of 1985, H.R. 3980, 99th Cong., 1st Sess. (1985).

dividends and 80/20 companies. Many states settled on taxing a small percentage of foreign dividends in lieu of providing factor representation for the foreign CFCs. But the difference in treatment of domestic 80/20 companies has continued, long after the foreign commerce clause arguments in *Container Corp.* and *Barclay's Bank* were put to rest. Kentucky, New Mexico, and Vermont adopted the domestic 80/20 company carveout in recent years, while New York, Massachusetts, and other states declined.

There are only limited discussions of the 80/20 rule in those states that went to water's-edge combined filing in the years immediately following the working group's report, or in states that adopted the 80/20 carveout more recently. As might be expected, the limited history suggests the purpose of the 80/20 rules was to avoid taxation of foreign-source income,[49] although that task is already accomplished through formulary apportionment.[50] But most courts see little value in that kind of legislative history.

The legislative history of Alaska's 80/20 exclusion was addressed in a 2017 decision of the Alaska Office of Administrative Hearings, concerning dividends paid by Costco's Nevada-based 80/20 company, Costco International Inc.[51] The taxpayer argued that its dividends should be excluded entirely by virtue of Alaska's conformity to IRC section 243, the exclusion for domestic dividends. The Alaska administrative law judge disagreed. Tracing the history of the state's 1991 adoption of water's-edge reporting, the ALJ noted testimony from an industry lobbyist conceding that some income reported by CFCs was properly attributable to domestic activities. The Legislature's solution was to include 20 percent of foreign dividends in the tax base to balance out the tax effects of the domestic activities and related expenses.[52] Because the Legislature intended the 20 percent dividends inclusion rule to represent domestic activity, the ALJ reasoned that the Legislature would have intended that dividends from Costco's 80/20 be similarly treated.

Other states have adopted similar reasoning in taxing a small percentage of foreign dividends in lieu of backing out related expenses or providing factor representation for the CFCs,[53] while other states exclude dividend income entirely. But the "rough justice" approach of taxing a small percentage of foreign dividends to represent domestic contributions to income (the new global intangible low-taxed income provisions are based on similar assumptions[54]) does not lend itself to 80/20 company dividends. The 80/20 companies may derive essentially all their income from domestic sources, as the *Target* and *PepsiCo* cases exemplify, since there are no controls on intangible property transfers. Nor can it be assumed, as we saw in *Target*, that the income will be "repatriated" back to the water's-edge group as a dividend instead of as a loan. After all, structuring the repayment as a loan allows the combined group to claim an additional deduction for interest expense.

Reductio ad Absurdum: The *Oracle* and *Agilent* Cases

Target did not mark the end of the 80/20 saga in Colorado. In 2019, during the waning days of the state's legislative session, two cases[55] were pending before the Colorado Supreme Court regarding the state's 80/20 company exclusion, Colo. Rev. Stat. section 39-22-303, that threatened

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[49] *See, e.g., Opinion of the Justices*, 509 A.2d 734, 740 (N.H. 1986); *PepsiCo* at 11.

[50] *See Barclay's Bank*, 512 U.S. 298, 311, fn. 10 (California was not taxing the foreign parent corporation by including its income in apportioned tax base.).

[51] *In the matter of Costco Wholesale Corp.*, OAH No. 16-0868/1325-TAX (2017).

[52] Alaska Stat. section 43.20.145(d). The ALJ noted that "with regard to the purpose of the 80 percent dividend-received deduction, the testimony regarding CSSB 119 explained that 'the percentage was set at 80 percent rather than 100 percent because certain expenses incurred by a domestic multinational parent are dedicated to support of income producing activities of the foreign parent.'" *Costco* at 14.

[53] One method for eliminating the potential for extraterritorial taxation while adhering to formulary apportionment principles is to include the factors of the payer in the water's-edge apportionment formula based on the ratio of income to dividends paid (the so-called Detroit formula). *See, e.g., Tambrands Inc. v. State Tax Assessor*, 595 A.2d 1039 (Me. 1991); and *NCR Corp. v. Comptroller*, 544 A.2d 764 (Md. 1988).

[54] IRC section 951A et seq.

[55] *Colorado Department of Revenue v. Agilent Technologies Inc.*, 441 P.3d 1012 (Colo. 2019), concerned a $15 million assessment, while *Department of Revenue of Colorado v. Oracle Corporation and Subsidiaries*, 441 P.3d 1021 (Colo. 2019), concerned a $5 million claim for refund.

to expose the state to hundreds of millions of dollars in refund claims.[56] The governor urged passage of S.B. 233 — legislation that would fix the statutory language prospectively, while including a declaration of prior legislative intent to help guide the court in its deliberations.[57]

Section 39-22-303 was enacted in 1985 in accord with the states' agreement to move to water's-edge reporting. One statutory section provided that neither the taxpayer nor the tax commissioner could include a C corporation on the combined return if the corporation had 80 percent or more of its property and payroll assigned to locations overseas.[58] A second provision, added later, defined an includable corporation as being any C corporation with at least 20 percent of its property and payroll assigned to locations in the United States and meeting four of six criteria evidencing a unitary relationship.[59]

The Colorado attorney general's office argued in both the *Oracle*[60] and *Agilent* appeals that the corporations were not true 80/20 companies because neither company had 80 percent of its payroll and property assigned to overseas locations (section 39-22-303(8)). The taxpayers in both cases argued that the companies were not includable corporations since neither company had more than 20 percent of its property or payroll assigned to domestic locations (section 39-22-303(12)).

How can it be possible, you may ask, that the companies could have neither 80 percent or more foreign factors nor 20 percent or less domestic factors? If the paradox has you thinking about the uncertainty principle or Schrödinger's cat, rest assured that the real answer is more mundane: Both corporate entities were pure holding companies, with no payroll or property *anywhere*. The Colorado Supreme Court resolved the statutory (if not existential) dilemma by concluding that the lack of domestic factors should control. A company with less than 20 percent domestic factors could not be an includable corporation under a plain-language analysis, period. The exclusion for companies with 80 percent or more foreign factors never entered the equation.[61]

There is a certain logic to the court's analysis. If a single overseas employee can constitute an 80/20 company, why not no employees? But what is so remarkable about the twin decisions in *Agilent* and *Oracle* is that neither opinion devoted a word to the purpose of or context for the exclusion of 80/20 companies. Had the court done so, it might have been able to read the "20 percent or less" and "80 percent or more" provisions in harmony to reach a different interpretation of the statute.[62]

The state made two other arguments in support of including the companies in the combined return that are worth noting. First, it argued that it would be appropriate to impute some domestic property and payroll to these paper companies since even the limited activity of recognizing income and transferring it to the parent required some physical activity. The court affirmed the findings of the lower courts that the tax department had failed to provide evidence to support its theory.[63]

The state also argued that it had authority under Colo. Rev. Stat. 39-22-303(6) — a statute patterned after IRC section 482 — to reallocate income and expenses among related parties to more fairly reflect the income generated in the state by the taxpayers (the two water's-edge groups). In *Joslin Dry Goods Co. v. Dolan*,[64] the

[56] Brian Eason, "How an Obscure Tax Case Became a $250 Million Political Fight at the End of the Legislative Session," *The Colorado Sun*, May 7, 2019.

[57] S.B. 19-233.

[58] Colo. Rev. Stat. section 39-22-303(8).

[59] Colo. Rev. Stat. section 39-22-303(12)(c).

[60] The MTC filed an amicus brief in the *Oracle* appeal supporting Colorado.

[61] The court's solution to the statutory puzzle presented a significant challenge for the state, since it suggested that no holding company could ever be included on a combined return (and arguably, no corporations owned through such a holding company structure could be included either).

[62] One could even take issue with the court's math. The statute called for the determination of a percentage, calculated by dividing the amount of the domestic factors of an entity by its overall (foreign and domestic) factors. Where the entity has no factors, as in these cases, the formula required that zero be divided by zero. But zero divided by zero is not zero. It is, instead, an indeterminate number, somewhat analogous to the indeterminate state of existence postulated for Schrödinger's cat.

[63] Illinois had success making a similar argument regarding an 80/20 company with a single employee in Bermuda. *Zebra Technologies Corp. v. Topinka*, 344 Ill. App. 3d 474 (1st Dist. 2003).

[64] 615 P.2d 16 (Colo. 1980).

Colorado Supreme Court held that requiring unitary combined filing was an appropriate means of accomplishing that reallocation. This time, however, the court held that that the adoption of a statute defining the contours of the unitary filing group had superseded the taxing agency's authority to reallocate income and expenses by combining (or de-combining) entities. That conclusion is particularly troubling in this context. Remedial statutes such as section 39-22-303(6) presuppose that transactions undertaken between related parties have followed the letter of the law (if not the spirit of the law). The statutes are premised on the belief that because the related parties are not truly dealing at arm's length, it is easier for them to achieve unintended tax effects from otherwise lawful transactions or structures.[65]

Presumably, if the problem a remedial statute is intended to fix has only been, or can only be, partially addressed by a legislative fix, the remedial statute continues to function, even if in a narrower context. The court's holding on section 39-22-303(6) serves to emphasize the importance of including a provision in the states' combined reporting statutes allowing for discretionary inclusion, or exclusion, of entities on a case-by-case basis to avoid distortions of income. Both the MTC's proposed model statutes include that authority.[66]

S.B. 233 was passed by the Colorado legislature shortly after *Agilent* and *Oracle* were decided, eliminating the 20 percent test prospectively. The exclusion of domestic corporations with 80 percent foreign factors remains, but henceforth, 80/20 companies will require at least one foreign employee and some property. Colorado's taxing authorities can continue to assert taxing jurisdiction over these companies in appropriate cases. But intangible property can take many forms, and not all revenue streams lend themselves as readily to a nexus determination as the trademark royalties at issue in *Target*.[67]

Bringing It All Back Home

Combined filing regimes, now used by most states that impose taxes on business activity profits, have gone a long way toward the elimination of domestic income-shifting opportunities. They do so by aligning the state tax base with the federal consolidated filing system, a system that is designed to reflect domestic profits (and some economic policy choices) in a consistent manner. Any exception to that congruence presents an opportunity for tax mischief.

It would be nice to think that we all agree that tax shelters are bad public policy, although we may not all agree on what constitutes a tax shelter. *Black's Law Dictionary* defines a tax shelter as a "financial operation or investment . . . that is created primarily for the purpose of reducing or deferring income tax payments."[68] IRC section 6662(d)(2)(C) defines a tax shelter as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax."

In the context of state corporate income taxation, one might define a tax shelter more broadly as any arrangement or plan intended to reduce tax liability that lacks either significant economic substance or discernable policy justification. Too often, these shelters owe their existence at least in part to the complexity of state business taxes and a lack of transparency inherent in taxation generally.

The states' exclusion of domestic 80/20 companies from the water's-edge return is not grounded in sound tax or economic policy. It

[65] Of relevance to state corporate income-shifting transactions described above, Treas. reg. section 1.482-1(f)(iii) asserts that the IRS can disregard the tax effects of a nonrecognition exchange undertaken under IRC section 351, if necessary, to achieve a fair reflection of income.

[66] MTC, "Proposed Model Statute for Combined Reporting" (amended July 29, 2011).

[67] *See* Sheldon H. Laskin, "Only a Name? Trademark Royalties, Nexus, and Taxing That Which Enriches," 22 *Akron L. J.* 1 (2007). A few states have included the sales factor in the determination of what constitutes an 80/20 company. *See, e.g.*, N.M. Stat. Ann. section 7-2A-2. This should go some way toward eliminating the potential for a paper company to claim 80/20 status while deriving substantial income from domestic sources. But the sales factor (now referred to as the receipts factor in many states) is not immune to purposeful manipulation efforts.

[68] *Black's Law Dictionary*, at 1691 (10th ed.).

was born of opportunity, sheltered from meaningful debate by the esoteric nature of the subject matter, and has been sustained by a lack of understanding of its operation and lack of public data on its revenue impacts. It is time for the domestic 80/20 exclusion to go. ■