Tax Insights & Commentary
Nov. 7, 2023, 4:30 AM EST

Pepsi Tax Case Shows Why 80/20 Exclusion Is a Bad Idea for States

The income tax dispute between PepsiCo Inc. and the Illinois Department of Revenue illustrates how 80/20 exclusion rules allow companies to shift their profits and reduce state tax revenue, says Bruce Fort of the Multistate Tax Commission.

PepsiCo Inc. v. Illinois Dept. of Revenue shines a light on an obscure state tax provision that facilitates profit shifting by multi-jurisdictional taxpayers: the exclusion of so-called 80/20 companies from the "water's edge" combined filing requirements of some 15 states. The attention is long overdue.

An 80/20 company is a domestic corporation, fully subject to federal tax, with at least 80% of its property and payroll located overseas. Not all 80/20 statutes are the same—some reference a since-repealed federal definition of an active foreign business in former Section 861(c)(1) of the tax code, while others address the sales factor as well. The distinctions are relatively minor in practical effect.

The 80/20 exclusion traces its roots to the 1984 Worldwide Unitary Taxation Working Group, convened in the aftermath of the US Supreme Court's decision upholding California's worldwide combined reporting system. Faced with threats of federal preemption of unitary combined reporting requirements, states agreed to discontinue mandatory worldwide combined reporting with the promise of increased federal enforcement of transfer pricing rules.

One of only two areas of disagreement in the final report was the proposed exclusion of domestic 80/20 companies from the water's edge return, as state representatives recognized the potential for abuse. Despite those objections, the 80/20 exclusion became a part of many—though not all—states' water's edge reporting systems in the 1980s.

Understanding how 80/20 companies can be used to shelter income requires an explanation of two key aspects of state corporate taxation.

First, most states' definition of 80/20 companies rely on the narrow definitions of "property" and "payroll" borrowed from the Uniform Division of Income for Tax Purposes Act. The UDITPA was intended to provide easily administered uniform rules for apportioning the incomes of manufacturing and mercantile firms. It never aimed to address the tax-motivated corporate structures and transactions seen today.

The UDITPA's measure of property is limited to real and tangible property, while the payroll factor is limited to W-2 employees. These bare-boned definitions allow for the creation of a non-combinable, non-taxed 80/20 company simply by locating a minimal amount of physical property overseas, while transferring the payroll responsibilities for a few employees already overseas to the new entity.

The second key point is the impact of states' conformity to the federal tax code. The tax code's income calculations are designed to function in the context of the federal consolidated filing system, similar in scope to the states' water's edge reporting, but for the 80/20 exclusion. Section 351 of the tax code plays a critical role in state tax minimization plans, as it allows domestic corporations to transfer tangible and intangible property to a newly created domestic subsidiary without tax recognition.

Such transfers are permitted under the federal tax code because the new entity will be subject to federal tax—and will almost certainly file on a consolidated basis with the transferor. By contrast, had that same transfer of assets been made to a foreign subsidiary, it would have subjected the US parent corporation to a tax under Section 367(d), to prevent the loss of revenue attributable to the transferred property.

With those points in mind, the picture of how the 80/20 exclusion allows companies to reduce state tax revenue becomes clearer. The UDITPA's definitions lack the subtlety and nuance required to address tax-motivated structures and transactions such as "loaned" employees.

Meanwhile, the states' departure from the federal consolidated taxing system provides the means to shift income away from the water's edge reporting group by allowing for untaxed transfers of income-generating intangible property to the 80/20 company.

The transfers are afforded non-recognition treatment even though the recipient is outside the states' taxing jurisdiction. Yet because the recipient isn't truly foreign, the transferring entity isn't subject to a corresponding tax liability.

Four decades after 80/20 companies entered the state tax lexicon, they remain a remedy in search of a problem. Although 80/20 companies sometimes are called foreign operating companies, it's an intentional misnomer. These aren't actual foreign companies, and they aren't required to meaningfully engage in foreign commerce, so concerns over international taxing conventions are misplaced. So too are suggestions that their foreign nature makes accounting more difficult.

It's unclear if the attention the *PepsiCo* case brings to the 80/20 exclusion will result in positive legislative changes.

In 2013, the Minnesota legislature eliminated its 80/20 provision in response to a state supreme court decision holding that the Department of Revenue was powerless to address profit shifting to a one-person 80/20 company, nominally located in the Cayman Islands. The Vermont legislature eliminated its 80/20 loophole in 2022.

But the Colorado legislature didn't act in 2017 after a district court in that state detailed how Target Corp. shielded $18 billion in income from the state's combined report by making royalty payments to its five-person 80/20 company in Hong Kong.

The mechanisms for income shifting outlined above equally apply to separate-entity filing systems. Although the states have responded in various ways, including challenges using comparable profits analysis, the legal structures that facilitate income shifting remain in place.

The best response would be to adopt a comprehensive combined filing statute including all unitary corporations in the combined group. The Multistate Tax Commission has developed two such models for states' consideration.

The case is PepsiCo Inc. v. Illinois Dept. of Revenue, Ill. Cir. Ct., No. 2022TX000155.

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