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States Can Fight Corporate Tax Avoidance by Requiring Worldwide Combined Reporting

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To reduce their federal corporate income taxes, every year large multinational corporations shift hundreds of billions of dollars in profits earned in the United States onto the books of subsidiaries formed in foreign tax havens like Bermuda, the Cayman Islands, and Ireland. Because nearly all state corporate taxes are based on the taxable profits a corporation reports on its federal return, each year states lose at least $10 billion — and perhaps as much as $15 billion — of revenue due to this profit-shifting, estimates suggest. This is substantial revenue states could be using to provide K-12 teachers with better pay and smaller class sizes, low-income college students with more adequate financial aid, uninsured individuals with health coverage, residents and businesses with better road maintenance, and other critical services.

Corporate profit shifting also hurts small businesses that lack the resources to set up their own foreign shell companies: they are at a competitive disadvantage because they aren't able to lower their taxes by shifting profits to tax havens, impeding their growth and local job creation.

States, however, have an effective remedy. They can dramatically reduce international tax avoidance by implementing a policy called "worldwide combined reporting" (WWCR). This method of tax accounting treats a parent corporation and most of its separately incorporated subsidiaries — including those established in foreign countries — as a single integrated economic enterprise (which, in reality, they are), requiring them to combine their profits as the first step in calculating their tax.

Worldwide combined reporting expands to corporations' *foreign* subsidiaries a practice that three-fifths of states with corporate taxes already apply to *U.S.* subsidiaries to prevent abusive interstate profit shifting. It nullifies the tax reduction from interstate and international profit shifting by enabling a state to tax a share of the combined profit of the members of the corporate group that operate in the state as well as those located in tax haven states (like Nevada and Wyoming, which lack corporate income taxes) and overseas tax havens.

Twelve states had implemented worldwide combined reporting by the early 1980s,[1] but they abandoned it under pressure from multinational corporations and the Reagan Administration.

[1] U.S. General Accounting Office, "Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving," July 1, 1982, https://www.gao.gov/assets/ggd-82-38.pdf. Page 31 of the report lists 13 states as

Alaska still requires oil companies to compute their state income tax using worldwide combined reporting,[2] and 11 states (including the District of Columbia) allow corporations to use worldwide combined reporting when it reduces their tax liability[3] — as it does in some cases for companies that aren't using tax haven avoidance schemes. In the early 1980s and again in the early 1990s, the U.S. Supreme Court upheld the constitutionality and fairness of worldwide combined reporting as a method of taxing multinational corporations.

All states with corporate income taxes would benefit from requiring all corporations with foreign parents or subsidiaries to calculate their tax liability using worldwide combined reporting.

International Profit Shifting Remains Pervasive

Overwhelming research and data demonstrate that abusive international profit shifting remains pervasive despite several provisions in the 2017 federal tax law aimed at curbing it.

For example, a 2023 report by economist Gabriel Zucman and colleagues estimated that U.S.-based multinational corporations (MNCs) shifted $369 billion in profits to 13 tax haven nations (counting Puerto Rico as a country) in 2022. This amount represents 46 percent of all foreign profits reported by U.S. MNCs. That 46 percent share is only slightly less than the 48 percent share estimated for 2017, evidence that the reforms in the 2017 tax law (the Tax Cuts and Jobs Act, or TCJA) have had little impact on the problem.[4] Foreign-parent MNCs with major operations in the U.S., like the major Japanese and Korean automakers, undoubtedly shift *additional* billions of dollars of profits out of the U.S. to low- or no-tax foreign countries.

Additionally, a 2020 study by economist (and former Deputy Assistant Secretary of the Treasury for Tax Analysis) Kimberly Clausing estimated that the federal government lost $60 billion to $94 billion in corporate income tax revenue in 2017 due to profit shifting.[5]

A number of other studies have further underscored the breadth and impact of international profit shifting:

"employing" WWCR: Alaska, California, Colorado, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon, and Utah. However, in 1984 a Massachusetts court held (in *Polaroid Corp.* v. *Commissioner of Revenue*) that the state lacked authority to require combined reporting, and the Indiana governor issued a letter forswearing it. Subtracting those two states from the 13 and adding Florida, which enacted worldwide combined reporting in 1983 but repealed it in 1984, produces a count of 12 states that required combined reporting at some point in the early 1980s.

[2] Alaska Statutes, Section 43.20.144, https://law.justia.com/codes/alaska/2022/title-43/chapter-20/article-2/section-43-20-144/; and Alaska Administrative Code, Section 15.20.300, (https://tax.alaska.gov/programs/documentviewer/viewer.aspx?251s.

[3] A review of state corporate tax statutes indicates that California, Idaho, Montana, New Mexico, and North Dakota default to WWCR but allow taxpayers to file on a "water's edge" (domestic-only) basis. Connecticut, the District of Columbia, Massachusetts, New Jersey, Utah, and West Virginia default to water's edge combined reporting but allow taxpayers to file using WWCR.

[4] Annette Alstadsæter *et al.,* "Global Tax Evasion Report 2024," EU Tax Observatory, October 2023, Table 2.2, p. 47, https://www.taxobservatory.eu/www-site/uploads/2023/10/global_tax_evasion_report_24.pdf.

[5] Kimberly A. Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act," *National Tax Journal*, December 2020.

- A 2021 Treasury Department study noted, "More U.S. profits are housed in tiny tax havens than in the major economies of China, India, Japan, France, Canada, and Germany combined."[6]
- A series of studies by a leading international tax economist and colleagues concluded that just six U.S. MNCs — Apple, Cisco, eBay, Facebook, Google, and Microsoft — underpaid their federal corporate income taxes by a combined $277 billion between 2009 and 2022 because of their abusive profit shifting practices.[7] The IRS recently sued Microsoft to recover $29 billion it claims the company owes for tax years 2004-2013 alone.[8]
- The use of tax haven subsidiaries is widespread among the largest MNCs.[9] For example, Walmart has subsidiaries in both Luxembourg and Singapore[10] despite having stores in neither location.[11] Blackstone has a staggering 326 subsidiaries in the Cayman Islands and 67 in Luxembourg.[12]

Profit Shifting Costs States Billions Each Year

Given the scale of international profit shifting, a reasonable estimate is that it costs states $10 billion to $15 billion each year.

Based on Congressional Budget Office (CBO) estimates of the scale of international profit shifting and the effect of the 2017 federal tax changes,[13] a 2019 Institute on Taxation and Economic

[6] U.S. Department of the Treasury, "The Made in American Tax Plan," April 2021, p. 9, https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf.

[7] These studies are summarized in Reuven S. Avi-Yonah *et al.,* "Commensurate with Income: IRS Nonenforcement Has Cost $1 Trillion," *Tax Notes Federal*, May 22, 2023.

[8] Microsoft Form 8-K filed with the U.S. Securities and Exchange Commission, October 11, 2023.

[9] Richard Phillips *et al.*, "Offshore Shell Games 2017: The Use of Offshore Tax Havens by Fortune 500 Companies," U.S. Public Research Interest Group Education Fund and Institute on Taxation and Economic Policy, October 2017, https://itep.sfo2.digitaloceanspaces.com/offshoreshellgames2017.pdf.

[10] Walmart 10-K annual report filed with the Securities and Exchange Commission for the fiscal year ending January 31, 2024, at https://www.sec.gov/Archives/edgar/data/104169/000010416924000056/wmtexhibit21fy24.htm. It's worth noting that Walmart's 10-K for the previous year indicated that the Luxembourg subsidiary had been incorporated in the Cayman Islands (https://www.sec.gov/Archives/edgar/data/104169/000010416923000020/wmtexhibit21fy23.htm); this is indicative of the ease with which MNCs can manipulate their corporate structures to minimize their taxes. Considerable research shows that compliance with SEC subsidiary reporting requirements is poor; a 2015 study found that Walmart, for example, had dozens of subsidiaries incorporated in tax havens. See Frank Clemente and Marc Auerbach, "The Walmart Web: How the World's Biggest Corporation Secretly Uses Tax Havens to Dodge Taxes," Americans for Tax Fairness, June 2015, https://americansfortaxfairness.org/files/TheWalmartWeb-June-2015-FINAL1.pdf.

[11] "Properties" section of Walmart 10-K for the fiscal year ending January 31, 2023, at https://www.sec.gov/Archives/edgar/data/104169/000010416923000020/wmt-20230131.htm#ic0762e37664541589e0e296d7f31d4ab_46.

[12] See https://www.sec.gov/Archives/edgar/data/1393818/000119312524044485/d734131dex211.htm.

[13] The ITEP estimate was based on CBO estimates that MNCs artificially shifted $300 billion in profits out of the United States annually and that the international tax provisions of TCJA would reduce that by $65 billion — for a net

Policy (ITEP) report estimated that states could recoup about $14 billion in annual revenue if they all required worldwide combined reporting. (The estimate assumed that all states first moved to within-U.S. or "water's edge" combined reporting, which 17 states have yet to do.)

While subsequent state actions have slightly reduced states' revenue losses from international profit shifting and thus the potential revenue gains from adopting worldwide combined reporting, the ITEP figure remains a reasonable rough estimate given that recent estimates of profit shifting are higher than the CBO estimate on which the ITEP study relied.[14]

WWCR Would Make Small Business More Competitive

Requiring worldwide combined reporting would provide a more level playing field for small businesses competing against multinational corporations. Small businesses (like the local coffee shop) compete with giant corporations that have the resources to set up shell companies abroad (like Starbucks, which has a Cayman Islands subsidiary).[15] Small businesses, along with individual taxpayers, end up paying more than their fair share of income tax to compensate for the taxes that MNCs avoid, which reduces the amount of money they can plow back into growing their businesses.

Also, MNCs' ability to pay lower taxes may enable them to obtain capital at a lower cost[16] and to underprice the local businesses. This has adverse ripple effects on local economic development and job creation, since less job growth in local small business means less money is injected into local economies.

Minimizing unfair competition based on tax advantages is particularly important for businesses owned by people of color and women, which already face multiple barriers to formation, survival, and growth. For example, businesses owned by people of color are less likely to receive venture capital investments.

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shift of $235 billion. See CBO, "The Budget and Economic Outlook: 2018 to 2028," April 2018, pp. 124 and 127, https://www.cbo.gov/system/files/2019-04/53651-outlook-2.pdf.

[14] Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole," Institute on Taxation and Economic Policy, U.S. PIRG Education Fund, SalesFactor.org, and American Sustainable Business Council, 2019, https://itep.sfo2.digitaloceanspaces.com/A_Simple_Fix_for_a_17_Billion_Loophole_USPIRGEF_ITEP.pdf. The ITEP study was written before it was known how many states ultimately would conform with TCJA provisions aimed at recouping some of the revenue lost to international profit shifting and how much federal revenue those provisions would generate. Thus, ITEP's $14 billion figure would have to be adjusted downward to reflect the effect this conformity has already had on state revenue, though the adjustment would be small since no large state has conformed. It should also be adjusted downward to reflect the fact that some states include in their tax base the dividends that foreign subsidiaries of MNCs pay to their U.S. parents. On the other hand, more recent estimates of post-TCJA profit shifting are considerably larger than the $235 billion CBO estimate on which the ITEP study relied. For example, the 2023 Zucman *et al.* study cited earlier in this paper estimates that U.S.-headquartered MNCs alone shifted $369 billion in profits to tax havens in 2022.

[15] See https://www.sec.gov/Archives/edgar/data/829224/000082922423000058/sbux-1012023xexhibit21.htm.

[16] Suppliers of new equity capital to a corporation will do so based on their expected after-tax rate of return. Therefore, if a corporation can reduce its federal and state tax liability through profit shifting, it has more profit available with which to pay dividends — enabling it to obtain more capital per dollar of dividends or obtain a fixed amount of capital with a lower dividend pay-out.

Despite Challenges, WWCR Is Legal and Consistent With Existing State Taxation

The U.S. Supreme Court has twice upheld the constitutionality of worldwide combined reporting.[17] MNC representatives widely assert that some of the principal alternatives to worldwide combined reporting, such as conforming with the anti-profit-shifting provision of the 2017 federal tax law related to global intangible low-taxed income (GILTI), are unconstitutional,[18] but courts likely would not agree, given these measures' commonalities with worldwide combined reporting. In any event, worldwide combined reporting is both theoretically superior to those alternatives and legally certain, so it should represent states' first and best option.

Alternative mechanisms for mitigating international profit shifting have practical shortcomings. For example, three states took an interim step toward full worldwide combined by requiring MNCs to include profits from subsidiaries formed in specified notorious foreign tax havens, like Bermuda and the Cayman Islands. But lobbying by MNCs and foreign countries ensured that these "blacklists" never included some of the worst offenders, like Ireland and the Netherlands, and ultimately succeeded in getting the policy repealed in two of the three states.[19] States have little to gain by adopting substantively inferior alternatives to worldwide combined reporting when MNCs have shown they will oppose them just as intensely.

Worldwide combined reporting is fundamentally consistent with the way all states tax corporations operating in more than one state, known as "formula apportionment." Regardless of whether they require combined reporting, no state requires multistate corporations to track which goods and services they sold to state residents, at what price, and what it cost to make each one — and therefore what the profit on each sale was. Instead, all states require them to apportion a share of their *nationwide* profit to the state for taxation, based on a formula that looks to the share of the corporation's objectively measurable activities that took place in the state.[20]

Under the formula now used by nearly all states, for example, if 10 percent of Walmart's nationwide sales are to California customers, 10 percent of its nationwide profit will be taxed by the state. States require formula apportionment to prevent corporations from manipulating their internal bookkeeping — for example, their assignment of overhead expenses to particular states — to reduce their state income taxes.

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[17] In *Container Corporation* v. *California Franchise Tax Board* (1983), the Court ruled that worldwide combined reporting applied to MNCs with a U.S. parent is constitutional. In *Barclays Bank* v. *California Franchise Tax Board* (1994), the Court ruled that worldwide combined reporting applied to MNCs with a foreign parent is constitutional.

[18] Less than three months after GILTI's December 2017 enactment, the Council on State Taxation (COST) — the trade association that represents the largest multistate corporations on state tax policy and legal matters — sent a letter to the Georgia legislature suggesting that state conformity with GILTI was unconstitutional. See https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-comments-and-testimony/03062018-ga-letter-to-gen-assembly-re.-foreign-income-taxation.pdf. And in October 2018, COST published a detailed article making the case. See Joseph X. Donovan *et al.,* "State Taxation of GILTI: Policy and Constitutional Ramifications," *Tax Notes State*, October 22, 2018.

[19] A tax haven blacklist was repealed in Montana and Oregon. It remains in effect in Colorado.

[20] If a state requires combined reporting, the formula is applied to the combined profit of the parent and subsidiaries; if it doesn't, the formula is applied separately to each member of the group — assuming the state can tax them.

Of the 45 states with corporate income taxes,[21] 28 states now require combined reporting for parent corporations and their subsidiaries operating within the United States — so-called water's edge combined reporting. These states understand that failure to require combined reporting negates a basic goal of formula apportionment. Without combined reporting, states *must* recognize a corporation's internal bookkeeping; for example, the prices charged on a sale from one member of a corporate group to another. But if water's edge combined reporting is recognized as a logical extension of formula apportionment, worldwide combined reporting must be as well — because MNCs can easily incorporate subsidiaries in other countries to perform many of the same functions as the subsidiaries they incorporate in other states.

In sum, requiring multinational corporations to use worldwide combined reporting to calculate their profits will help ensure they pay their fair share of state tax, thereby reclaiming vitally needed state revenue for investments that benefit all residents and helping level the playing field for small local businesses.

[21] See https://www.cbpp.org/28-states-plus-dc-require-combined-reporting-for-the-state-corporate-income-tax. Texas does not have a traditional corporate income tax but is counted as a combined reporting state here because it requires combined reporting for its "margins tax" to prevent potential interstate profit shifting.