# *Pass/Fail Analysis of Water's-Edge Unitary Tax Regimes: Which Ones Pass Constitutional Muster on Their Treatment of Unitary Foreign Income?*

By Greg Rottjakob and Joseph Schmidt

"An unlimited power to tax involves, necessarily, a power to destroy."[1] "That the power of taxing it by the States may be exercised so as to destroy it, is too obvious to be denied."[2] While these words are infamous with one of the seminal cases that helped establish the judiciary as a co-equal branch of the government, the U.S. Supreme Court ("the Court") has lost its way to grant cert to any significant corporate state income tax case since *Kraft*[3] in 1991, thereby allowing states to destroy taxpayers at their will. The state's departments of revenue, untethered to the principles of the Due Process and Commerce Clause or even the threat that the Court will review a corporate state income tax case, are encouraged to be as aggressive as they can to maximize the collection of tax for their state. Taxpayers, on the other hand, are licking their wounds and willing to concede to blatant injustices because why waste time, effort, and money if you never get your case heard in an unbiased forum? Part of the issue is that taxpayers and their advisors are not coming up with different approaches to point out the state law and constitutional violations. Taxpayers and their advisors must develop a new approach. The question becomes when will a taxpayer frame the issue properly to get the Court to grant cert to a state income tax case?

That time is now. Though you may not be aware of it, we are amid an awakening to the need for taxpayers to revise accepted notions of what is fair in light of amped up stakes as a result of federal tax reform in 2017: Tax Cuts and Jobs Act[4] (TCJA). For some of us, it begins when we listen to a debate among our inner voices. One voice pipes up when we see GILTI (the acronym for global intangible low-taxed income) or foreign dividends (collectively, "foreign inclusions") included in the water's-edge state income tax base for global unitary taxpayers.[5] It's the voice that says, "Something doesn't seem quite right from a fairness perspective." That's when another inner voice chimes in with the accepted adage that the U.S. Supreme Court is seemingly tolerant of anything the states devise in terms of

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imperfect unitary formulary methodologies. This is what is often characterized as "rough justice" in reference to what taxpayers must be resigned to accept as something that is extremely unlikely to be taken up by the Court for review. That is about to change.

In this article, we'll distinguish what the Court has indicated it will tolerate versus what the Court indicated that it will strike down. With that benchmark, we'll put to the test all water's-edge regimes and grade them pass/fail. Finally, we will make predictions on how we believe controversies will reshape commonly accepted thoughts about "rough justice" that we believe will lead to a fairer amount of tax being rendered on a taxable income base augmented by foreign inclusions.

## I. Some History

During the 1980s, there was turmoil around the concept of imposing state income tax *via* worldwide unitary formulary apportionment ("worldwide"). Many states had adopted worldwide, but its unpopularity within the corporate taxpayer community and the threat of action by the federal and foreign governments[6] led most states to retreat to the "water's edge" of the unitary group for formulary apportionment purposes, or at least to permit water's-edge as an elective option.

*The water's-edge states with facially discriminatory systems taxing income from unitary foreign subsidiaries will likely see a significant uptick in litigation by taxpayers challenging the constitutional merit of these statutory arrangements.*

As the name implies, the water's-edge concept involves narrowing the scope of the worldwide unitary filing group to those members operating predominantly in the U.S. Generally, states parse the group on a corporation-by-corporation basis to determine taxable income by apportioning the domestic U.S. water's-edge group based on in-state apportionment inputs over totals for the domestic group. Seems simple enough; first allocate income among the foreign and the domestic activities of the worldwide unitary group, and then apportion the income of the domestic group to arrive at state taxable income. The Court has indicated that it won't dictate one manner of allocation/apportionment methodologies for states to utilize and, further, that it will tolerate imperfections in terms of incidental extraterritorial taxation. On cue, several states decided to test the limits of the Court's tolerance for imperfections by layering onto the water's-edge income base some portion of income from the foreign subsidiaries that were otherwise excluded from the water's-edge filing group.

Taxpayers have challenged the inclusion of the foreign subsidiary income in water's-edge context on both Due Process and Commerce Clause grounds. Several taxpayers took appeals to state supreme courts, but none were successful. Nor were any of these cases taken up by the Court (request for review by the U.S. Supreme Court of *General Electric Co. v. Commissioner, New Hampshire Department of Revenue* was denied, October 29, 2007. Docket No. 06-1210).

## II. Guidelines from the U.S. Supreme Court

The two seminal U.S. Supreme Court cases we will use to guide us in the analysis of the water's-edge tax regimes are *Container*[7] and *Kraft*.

### A. *Container*

The Court has consistently favored formulary apportionment when including items of income. As the Court stated in *Container Corporation v. California*:

> It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of formula taking into account objective measures of the corporation's activities within and without the jurisdiction. This Court long ago upheld the constitutionality of the unitary business/formula apportionment method … the method has now gained wide acceptance …

But with respect to formulary apportionment, the Court added: "Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. … Besides being fair, an apportionment formula must

… also not result in discrimination against interstate or foreign commerce."

Fairness principles of the Due Process Clause demand that a logical relationship exists between the income being apportioned and the factors used to measure what portion of that income reasonably relates to in-state activities. Thus, in *Container*, the taxpayer's worldwide income was apportioned to California by factor numerator inputs representing the taxpayer's presence within California—California sales, California property, and California payroll of the taxpayer. The denominator consists of the worldwide totals for sales, property, and payroll. Accordingly, the rule that we will use to bench-test whether the various water's-edge tax regimes devised by states are "fair" from a Due Process and Commerce Clause perspective will be based upon a logical relationship to the facts and ultimate holding in *Container*. In other words, to the extent that income of a global unitary business enterprise is to be included in taxable income in a given state, there must be equal dignity with respect to factor representation of whatever fractional part of the underlying business is being included by a state.

Our focus will be on the act of partitioning a global unitary business enterprise into the domestic, or water's edge, component that comprises the filing group and that portion of the unitary business that was cast out as beyond the water's edge, or foreign. The proper name to describe this methodology is separate accounting. According to Walter Hellerstein, "[u]nder the separate accounting method, a certain geographic or functional area of an interstate business is treated separately from the rest of the business. Income is computed as if the activities of the business were confined to that geographic or functional area."[8] The partitioning of the global unitary business does not render the domestic and foreign groups as no longer operating a global business enterprise in a unitary manner. Referring back to *Container*, the Court observed that, at least at the purest end of the conceptual continuum, "[i]t rejects geographical or transactional accounting …." In a way, states embracing the use of formulary apportionment in lieu of separate accounting are displacing an objective, results-oriented, competitive environment, wherein "winners" and "losers" are pitted against each other, in favor of issuing all members "participation" awards. Even the losers are acknowledged for their contributions to overall team results. Continuing along the logical path this takes, the individual results disappear, and all activities of the unitary group are "homogenized" as the first step in determining state taxable income, which is arrived at by simply apportioning the overall income or loss of the combined group. Although states and tax professionals alike seem to ignore it, there is inherent conflict when the homogenized unitary group results are partitioned through the use of separate accounting, and yet that is exactly what states do at the outset in applying water's-edge unitary accounting.

Actually, the concept of "water's-edge formulary apportionment" is oxymoronic in that it is the collision of diametrically opposed approaches to arriving at a fair amount of income associated with in-state activities. The decision by a state to partition a global unitary business enterprise into domestic and foreign portions places reliance on rules that establish whether the income of the affiliated group or unitary business enterprise are fairly accounted for at the transactional level (*i.e.*, transfer pricing). In general, this functionality exists for state income tax purposes *via* adoption of the Internal Revenue Code (IRC). Accordingly, the premise of water's-edge unitary formulary apportionment depends on the quality of transfer pricing among the domestic and foreign partitioned groups and then, in turn, the quality of the apportionment formula applied when arriving at a fair amount of income to associate with the global unitary business enterprise's in-state activities.

## B. *Kraft*

The narrow holding of *Kraft* was that a state may not treat dividends from foreign corporations less favorably than dividends from domestic corporations when taxing the income of a separate corporation. Most taxpayers have swung for the fence on this issue, turning it into a binary question of exclusion (or the state's argument of inclusion).[9] A better reasoned and relevant interpretation of *Kraft*, for purposes of this discussion, is that a state tax methodology that *inevitably* results in extraterritorial taxation will not survive Commerce Clause scrutiny. In contrast, as observed by the Court in *Container*, *incidental* extraterritorial taxation is permissible. By incidental, we mean where the apportionment inputs may be unequal because of drastic differences in economic factors by region. This was the case in *Container*, wherein the lower pay levels relative to profit contributions for operations in China versus in California resulted in skewing of the apportionment to California. But the Court observed this as not inevitable as facts will be different by taxpayer and are subject to change over the course of time. By inevitable, we do mean with certainty. For example, imagine a worldwide formulary apportionment where only 50% of foreign sales are included in the factor denominator. It is obvious that using such a formula will, with certainty, result in an undue amount of foreign income being attributed to the state using such a formula. We use the word "obvious" in the prior sentence because most rationally minded state tax practitioners, both state officials and taxpayers alike, see the inevitability of overtaxation in the example and inherent constitutional issues. However, when you call such an inclusion GILTI or a dividend and not allow for commensurate sales, the inherent unfairness of the resulting tax is not seemingly readily comprehended.

To recap, the Due Process and Commerce Clause constraints that a water's-edge regime must meet are the following:

1. A global unitary business enterprise divided into domestic and foreign groups, followed by formulary apportionment of the domestic group, is presumptively fair, given that the apportionment of the domestic mirrors the worldwide formulary unitary apportionment sanctioned by the Court in *Container*.
2. Foreign inclusions from unitary foreign subsidiaries remain income from unitary affiliates. To simulate the fairness principles sanctioned by the Court in *Container*, commensurate apportionment factor representation is required. In other words, to the extent that a portion of unitary foreign income is included in the domestic group income base, the apportionment factor denominators must include foreign sales, property, and/or payroll to the extent these inputs rationally relate to the income being apportioned.
3. Not adhering to these guidelines inevitably results in extraterritorial taxation of foreign commerce, which, according to *Kraft*, is impermissible.

## III. Grading the Water's-Edge Regimes

We bench-tested 31 water's-edge unitary tax regimes against the standards given to us by the Court in *Container* and *Kraft*. 21 failed to pass Constitutional muster for Due Process and Commerce Clause purposes. Several of these would have passed prior to the TCJA, but jurisdictions such as Nebraska and New Jersey concluded that GILTI and/or deemed repatriation income recognition pursuant to Code Sec. 965 do not qualify as a deemed dividend, while New York City and Washington, D.C. have not acted to exempt GILTI. The results are provided in the following schedule presented as Chart 1.

It is interesting to note, states that have passed our evaluation have done so by excluding the foreign dividends in the tax base. In essence, they are taxing only a fairly apportioned share of what their legislatures have deemed water's edge or United States based. This does not mean that if a state had a regime that included the foreign dividend it could not get a passing grade. However, to pass there would have to be commensurate apportionment representation relative to foreign unitary inclusions. The fact of the matter is that this is not a complicated concept, but the greed of states to raise revenues and the unchecked nature of these decisions by the Court has led to this unbalanced approach.

## IV. Myths Regarding Taxation of Foreign Inclusions and Water's-Edge Tax Methodologies

In *Amdahl v. Franchise Tax Board*,[10] the Court determined that the legislative intent for the effective inclusion of 25% of income from unitary foreign subsidiaries (dividends net of the 75% dividends received deduction) was that such dividends are includible in the apportionable income base because the income from which the dividends are paid was not previously included in the income for the water's-edge combined reporting group. This is a common refrain for water's-edge states that tax income from unitary foreign subsidiaries. These states commonly think that the income from foreign corporations that was deferred can now be taxed upon repatriation.

The insinuation is that the foreign income somehow escaped the rightful taxation by a state when it was generated, and that it is now time to pay the piper. But earlier, we discussed how water's edge is a fusion of separate accounting (dividing income from "domestic" activities versus income from the "foreign" activities) and formulary apportionment of the domestic group to determine state taxable income. Having allocated the domestic and foreign income at the outset, then, unless a state can show distortion in the separate accounting utilized to parse income of the worldwide group to the domestic and the foreign groups, it follows that foreign income was taken into account in the year that it was generated when arriving at state taxable income. Therefore, it would be illogical to include dividends paid from those earnings as there was no deferral. In fact, including foreign dividends in apportionable income for a water's-edge group creates distortion, by definition, unless the state were to (1) establish, as a threshold matter, that the original separate accounting was itself distorted, and further, that (2) including the foreign dividends corrects the distortion found to exist in the separate accounting of foreign and domestic activities of the worldwide group.

Another common case cited by states regarding the entitlement to tax foreign dividends is *Mobil*,[11] which is truly ironic. The Court made conspicuously clear at the outset of the opinion that the apportionment scheme utilized by Vermont was *not* endorsed by the Court.[12] In fact, Vermont included dividends from

**CHART 1.**

| *Water's-Edge State* | *Foreign Unitary Income Included* | *Factor Relief* | *Description of Effect on Foreign Commerce* | *Tax Burden* | *Result* | *Grade* |
|---|---|---|---|---|---|---|
| **Alaska** | 20% net GILTI, divs, subpart F, & foreign royalties | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Arizona** | Reasonable expense disallowance | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **California** | 25% of divs and subpart F income | Partial factor relief allowed for underlying factors of foreign subsidiary from which foreign income is sourced (*see* Note 2) | Statutory factor relief under-represents the foreign income included in the base subject to apportionment | The "by-legal entity" factor relief formula creates a gauntlet that prevents full factor relief to pass through from lower-tier unitary subsidiaries | Facially Discriminatory | Fail |
| **Colorado** | Inclusion depends on foreign tax rate | Limited to foreign inclusion (*see* Note 3) | Extra-territorial tax on foreign income results from under-representation in the apportionment factor, to the extent the foreign income isn't otherwise excluded via the Colorado foreign-source income exclusion computation | Inevitable to the extent the foreign-source income is included | Facially Discriminatory | Fail |
| **Connecticut** | Mandatory 5% expense disallowance | N/A | To extent in excess of reasonable expenses, then incidence of tax falls on foreign income that is unaccompanied by factor representation | Inevitable to the extent that the mandatory expense disallowance exceeds a reasonable amount of expenses to associated with exempt foreign-source income | Facially Discriminatory | Fail |
| **District of Columbia** | 100% of GILTI | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Hawaii** | Reasonable expense disallowance possible | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **Idaho** | 15% (or 20%, depending on ownership level) of net GILTI, divs and subpart F income | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Illinois** | Reasonable expense disallowance possible | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **Kansas** | 20% of net GILTI, divs, and subpart F income | Limited to gross amount of foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Kentucky** | Reasonable expense disallowance | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |

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| *Water's-Edge State* | *Foreign Unitary Income Included* | *Factor Relief* | *Description of Effect on Foreign Commerce* | *Tax Burden* | *Result* | *Grade* |
|---|---|---|---|---|---|---|
| **Maine** | 50% of GILTI, divs, and subpart F income | None (*see* Note 1 regarding the "Augusta formula") | Tax on foreign source income with no factor representation | Inevitable | Facially Discriminatory | Fail |
| **Massachusetts** | Mandatory 5% expense disallowance | N/A | To extent in excess of reasonable expenses, then incidence of tax falls on foreign income that is unaccompanied by factor representation | Inevitable | Facially Discriminatory | Fail |
| **Michigan** | Reasonable expense disallowance possible | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **Minnesota** | Reasonable expense disallowance possible | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **Montana** | 20% of net GILTI, divs, and subpart F income | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Nebraska** | Net GILTI and subpart F income | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **New Hampshire** | Net GILTI and divs | Partial factor relief allowed for underlying factors of foreign subsidiary from which foreign income is sourced (*see* Note 2) | Extra-territorial tax on foreign income results from (1) under-representation in the apportionment factor used to apportion foreign-source income, (2) not similarly providing foreign-source income factor relief for the "domestic" portion of the income subject to apportionment, and/or (3) utilizing the "domestic" apportionment numerator to apportion the "foreign" portion of income subject to apportionment (*see* Note 2) | Inevitable | Facially Discriminatory | Fail |
| **New Jersey** | Net GILTI, taxable dividends, and 5% taxable deemed dividends (this would include subpart F income), plus 100% of distributions out of previously taxed earnings and profits received by entities relative to income recognized for federal tax purposes in years prior to when the recipient was subject to New Jersey income tax | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |

**CHART 1.**

| *Water's-Edge State* | *Foreign Unitary Income Included* | *Factor Relief* | *Description of Effect on Foreign Commerce* | *Tax Burden* | *Result* | *Grade* |
|---|---|---|---|---|---|---|
| **New Mexico** | None | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **New York City** | Net GILTI and 5% of subpart F income and 5% of taxable distributions | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **New York State** | 5% of (1) net GILTI, subpart F income, and taxable dividends | Limited to foreign inclusion (*see* Note 4) | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **North Dakota** | 30% of net GILTI, divs, and subpart F income | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Oregon** | 20% of GILTI and divs | Limited to foreign inclusion (*see* Note 5) | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Portland/ Multnomah** | 20% of GILTI and divs | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Rhode Island** | 100% of net GILTI | Limited to foreign inclusion | Extra-territorial tax on foreign income results from under-representation in the apportionment factor | Inevitable | Facially Discriminatory | Fail |
| **Texas** | None | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **Utah** | 50% of GILTI, divs, and subpart F income | Partial factor relief allowed for underlying factors of foreign subsidiary from which foreign income is sourced (*see* Note 2) | Statutory factor relief under-represents the foreign income included in the base subject to apportionment | The "by-legal entity" factor relief formula creates a gauntlet that prevents full factor relief to pass through from lower-tier unitary subsidiaries | Facially Discriminatory | Fail |
| **Vermont** | Net GILTI and divs | Partial factor relief allowed for underlying factors of foreign subsidiary from which foreign income is sourced (*see* Note 2) | Extra-territorial tax on foreign income results from (1) under-representation in the apportionment factor used to apportion foreign-source income, (2) not similarly providing foreign-source income factor relief for the "domestic" portion of the income subject to apportionment, and/or (3) utilizing the "domestic" apportionment numerator to apportion the "foreign" portion of income subject to apportionment (*see* Note 2). | Inevitable | Facially Discriminatory | Fail |

**CHART 1.**

| *Water's-Edge State* | *Foreign Unitary Income Included* | *Factor Relief* | *Description of Effect on Foreign Commerce* | *Tax Burden* | *Result* | *Grade* |
|---|---|---|---|---|---|---|
| **West Virginia** | None | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |
| **Wisconsin** | Reasonable expense disallowance | N/A | Impact is "fair" per the U.S. Supreme Court principles espoused in Container | Incidental | Non-discriminatory | Pass |

**Notes:**

1) Maine has adopted what is referred to as the Augusta formula, pursuant to which a ceiling is placed on the total tax in apparent recognition that the scheme to tax 50% of income from unitary foreign subsidiaries with no factor representation whatsoever as being fatally flawed for Due Process and Commerce Clause purposes. In accordance with the formula, tax cannot exceed the amount computed on a worldwide basis, but tax on a domestic basis without foreign inclusions is established as a minimum. What's remarkable about the Augusta formula is that it's very existence supports the assertion that the Maine Department of Revenue is aware of constitutional infirmities with regard to the corporate income tax statutes and, apparently, have pre-emptively exercised discretion to depart from the statutes in an apparent effort to cure the problem, which presents yet another problem. The Maine legislature has not adopted worldwide unitary taxation. Rather, at least ostensibly, the Maine legislature adopted water's-edge unitary tax, albeit flawed, in an attempt to tax income from unitary foreign subsidiaries. Query whether the Maine Department of Revenue's exercise of discretionary authority under Maine Revised Statutes Annotated Section 5211.17 is invalid, given that no diligence was performed to show that "clear and cogent evidence" of distortion mandates the departure from statutory provisions. Is what the legislature adopted as a taxing scheme a mere suggestion for the Department, to which the Legislature apparently delegated untethered discretion to devise a worldwide unitary taxing scheme?
2) States that have adopted apportionment factor relief with respect to the inclusion of income from unitary foreign corporations include California, New Hampshire, Utah, and Vermont. The rules devised by these states provide a pro rata inclusion into the apportionment denominator for the underlying factors of the foreign corporation or legal entity from which the foreign income originated. Generally, the ratio is the income being included divided by current year earnings and profits or taxable income. All of these states limit the ratio to 100% (which creates inequities in years where accumulated earnings are distributed or deemed distributed, such as what occurred in tax years 2017 and 2018 with respect to deemed repatriation income recognition under Code Sec. 965). Though the rules adopted by this group of states appear to provide meaningful relief relative to income from unitary foreign corporations, they share the common characteristic of treating, for purposes of computing the apportionment relief, each foreign subsidiary on a separate entity basis in contravention of the adoption of unitary formulary tax accounting conventions. Limiting factor relief to a ratio of the underlying factors of the individual corporate entity from which the foreign income originates is designed to minimize apportionment relief since most corporate structures are complex and involve the use of holding companies. As a result, there are few, if any, apportionment attributes available where holding companies are the source of the foreign income being recognized, as is the case in the majority of fact patterns. Accordingly, these statutes operate merely to create the appearance of fairness with respect to providing factor relief relative to the foreign income that these states include in the income base subject to apportionment, a wolf in sheep's clothing. There are additional problems with the scheme adopted by New Hampshire, which are the topic of a separate article by the authors (New Hampshire's Preposterous Taxation of Income from Foreign Subsidiaries, J. State Taxation, Spring 2002).
3) Colorado statutes focus on the federal foreign tax credit calculation. Generally, if creditable foreign tax equals or exceeds the federal foreign tax credit, then no foreign-source income is included. When creditable foreign taxes are below the federal foreign tax credit limitation, foreign income is included inverse to the extent of foreign tax versus federal tax. Thus, the amount of foreign income included for Colorado purposes depends on the extent to which foreign jurisdictions taxed the same income at lower rates. From a Commerce Clause perspective, this raises questions about whether this is a fair manner in which to attribute income to in-state activities.
4) New York State included net GILTI in the income base with apportionment factor representation limited to the foreign inclusion for one tax year only: 2018. The analysis of New York State is based on current treatment of income from foreign subsidiaries.
5) Whether the foreign-source income from foreign subsidiaries net of dividends received deductions can be included in the apportionment factor denominator has been challenged by the Oregon Department of Revenue (*Oracle Corp. v. Department of Revenue*, Oregon Tax Court, No. TC 5340, October 6, 2021). For purposes of this analysis, we've assumed this will be resolved such that at least the income recognized is included in the apportionment factor denominator.

unitary foreign subsidiaries in the income base of a single corporation whose income was apportioned to Vermont based strictly on the Vermont share of apportionment measures for the domestic activities of the corporation filing returns with Vermont. No modifications to the apportionment denominator were made to reflect either the foreign dividends received or the underlying sales, property, or payroll of the unitary subsidiaries relative to generating the income from which the dividends were paid. So, while it is fair for states to cite *Mobil* as the authority for taxing dividends from unitary foreign subsidiaries, the fact of the matter is that including foreign income with the domestic group income creates a hybrid version of worldwide income. According to the principles of fairness given by the Court in *Container*, the extent to which foreign income is included requires the inclusion of a commensurate amount of apportionment denominator input relative to the foreign income included in order for the foreign inclusion to result in a fair amount of income associated with the in-state activities of the taxpayer.

Another myth is that the group of states that include foreign income in the tax base (*e.g.*, California, New Hampshire, Utah, and Vermont) provide meaningful apportionment relief with respect to income included from the otherwise excluded unitary foreign affiliates. The concept starts well intentioned, in that the extent to which income is included leads to factor representation *vis-à-vis* underlying factor attributes of the foreign group that generated the income being included in the apportionable base. But the execution is flawed such that there will be meaningful relief only in the most exceptional set of circumstances. Based on our extensive experience in serving and working for profitable global concerns, they have complex legal organization structures comprised of literally hundreds or often thousands of legal entities. And yet, each one of these states looks only to the immediate top-tier foreign unitary subsidiary, usually a foreign holding company, from which the income was derived, meaning a dividend from the holding company by the domestic group for factor inputs. As a result, the factor relief allowed is usually paltry because the underlying factor attributes do not relate to the entities that generated the foreign inclusion. Ironic that legal entity demarcation is inserted into what should be a reasonable application of unitary formulary apportionment. Adding insult to injury, the ratios used to determine the extent of apportionment attributes to include in the apportionment denominators is limited to 100%, even though, as especially was the case with respect to TCJA deemed repatriation income recognition, the foreign inclusions often represented up to 30 years of accumulative earnings.

## V. Final Thoughts

State tax practitioners should borrow the slogan of the revolutionary war in this fight to remain focused: "Taxation without [factor] representation is tyranny!" The water's-edge states with facially discriminatory systems taxing income from unitary foreign subsidiaries will likely see a significant uptick in litigation by taxpayers challenging the constitutional merit of these statutory arrangements. There is a compelling need for the Court to take "water's edge" as an untested construct by the Court. Our hope is that the Court takes up a water's-edge case to clarify the proper interpretation of "rough justice" that it gave us in *Container*.

### ENDNOTES

1 Daniel Webster, arguing the case in *McCulloch v. Maryland*.

2 *McCulloch v. Maryland*, SCt, 17 US 327 (1819).

3 *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, SCt, 505 US 71, 112 SCt 2365 (1992).

4 Tax Cuts and Jobs Act of 2017, Public law: 115–97.

5 Note that there are numerous other types of foreign inclusions (*e.g.*, 20% or more activity within the United States, federal ECI determined without regard to treaties, tax haven, or U.S. source FDAP), but for purposes of this article, we'll focus only on GILTI and dividends. Additionally, we have taken as a given that all domestic and foreign subsidiaries meet common law tests of unity.

6 Criticism from the UK (Margaret Thatcher threatened retaliation in a letter to then President Ronald Reagan), Japan, and other countries led the Reagan administration to form a "Working Group" to study the problem. Interestingly, the Group could not agree on the treatment of foreign dividends by water's-edge filers.

7 *Container Corp. v. Franchise Tax Bd.*, SCt, 463 US 159, 103 SCt 2933 (1983).

8 Walter Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 MICH. L. REV. 113 (1980), at 117.

9 *See* authors' article, "*New Hampshire's Preposterous Taxation of Income from Foreign Subsidiaries*" for a discussion of *Kraft* footnote 23 and *Container,* 40 Journal of State Taxation 41 (2022).

10 *Amdahl Corp. v. Franchise Tax Board*, Court of Appeal of California, First District, 15 Cal. Rptr. 3d 473, July 7, 2004.

11 *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, SCt, 445 US 425, 100 SCt 1223 (1980).

12 The issue before the Court in *Mobil* did not include what is fair apportionment relative to the included foreign-sourced income (*i.e.*, what foreign factors are to be input into the apportionment factor denominators). "In keeping with its litigation strategy, appellant has disclaimed any dispute with the accuracy or fairness of Vermont's apportionment formula … It is evident from the transcript of the hearing before the Commissioner that appellant's principal object was to achieve the subtraction of the asserted non-apportionable income from the pre-apportionment tax base; the alternative request for modification of the apportionment formula went largely undeveloped."