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by Don Griswold

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In this installment of Just SALT, Griswold continues a six-part series on corporate income tax reduction planning. In part 2, he illustrates state countermeasures and proposes that the best is true unitary combined reporting.

The aim of this six-part series is to strengthen corporate income tax (CIT) auditors' and policymakers' ability to counter lawful state CIT reduction planning. An appreciation for the broad principles underlying this planning and its constantly evolving innovations, I hope, will put into stark relief two realities: First, the tax avoidance community's innovations will always be steps ahead of auditors and legislators; and second, current countermeasures are inadequate. Only by taking unitary combined reporting to the next level can government solve the CIT avoidance problem. I recommend that states adopt true unitary combined reporting (TUCR), described below.

Part 1[1] of the series offered a CIT primer from a planner's perspective and illustrated "building blocks" that are foundational to much CIT planning. Parts 3 through 6 will group related state CIT planning strategies into "families," and illustrate them in analysis and in figures. The reader may find it useful to refer to the legend provided in Figure 1 in the first article. Figures will be numbered consecutively across the series, for ease of cross-referencing.

Introduction to State Countermeasures

The least effective way to stop corporations from avoiding $17 billion in CIT every year[2] is to enact an endless series of one-off loophole closures targeted at each planning strategy as it hits the newspapers — as happened in a number of states after Walmart's real estate investment trust-based CIT reduction strategy was outed publicly by *The Wall Street Journal*.[3] This approach captures only the tiniest tip of the avoidance iceberg and allows clever planners to tweak the strategy in response to each law change so that even the visible tip does not remain neutralized for long.

Substantive countermeasure development properly starts for government at the same place that substantive planning innovation starts for corporations — that broad formula discussed in the primer in part 1 of this series:

*If **jurisdiction**, then*

*Tax = [**Tax Base**] x ([Statutory Tax Rate] x [**Apportionment** %]*

*subject to separate or combined **filing method** rules.*

[1] Don Griswold, "Innovation Principles for Multistate CIT Planning — Part 1," *Tax Notes State*, May 16, 2022, p. 729.

[2] *See* Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens," Institute on Taxation and Economic Policy, at 10, 14, 15 (Jan. 2019); Griswold, *supra* note 1, discussion at fn. 2.

[3] Jesse Drucker, "Wal-Mart Cuts Taxes by Paying Rent to Itself," *The Wall Street Journal*, Feb. 1, 2007.

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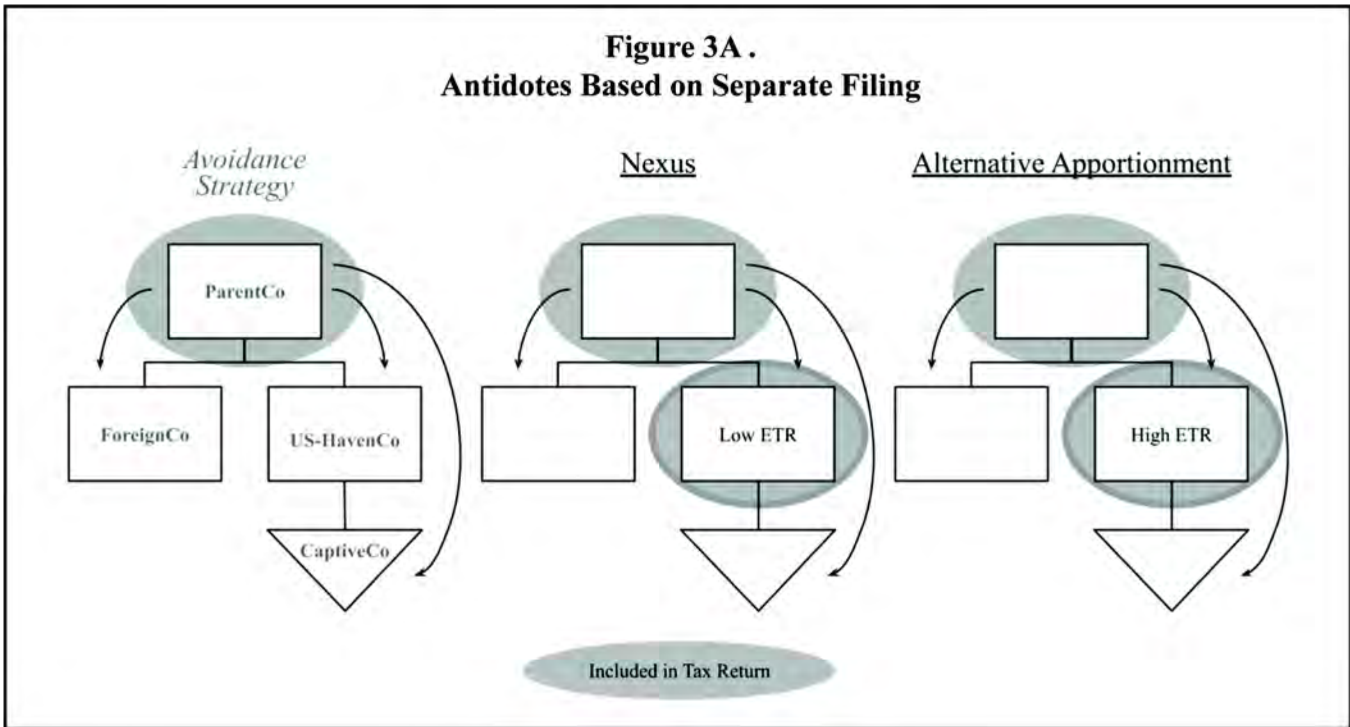

Readers will recall that three core attributes in this formula — jurisdiction (nexus), tax base, and apportionment — can be manipulated by the planner and used as building blocks to create a wide variety of CIT reduction strategies. They will also note that a fourth core attribute — filing method — can be altered by a state legislature.

Antidotes Grounded in Separate Filing

Nearly half the states that impose a corporate income tax still require or allow corporations to file using the separate-filing method.[4] Under this method, a legal entity must file its own separate CIT return if it has in-state nexus; tax base and apportionment factors of affiliated entities within the corporate group are excluded from the calculations in these returns. In contrast, other states adopt some form of the unitary combined reporting method, which reflects the economic reality that corporate groups act for all intents and purposes like a single enterprise, and so includes tax base and apportionment factors of more members of that group, whether those entities have nexus or not.

Separate-filing states pursue one or more of seven primary antidotes — by statute or on audit — that can produce some incomplete reduction of CIT avoidance. Each such countermeasure has been, and continues to be, subject to significant audit litigation, making each of these antiabuse methods costly, time consuming, and uncertain in its results.

Figures 3A and 3B illustrate five of these antidotes, applied to a generic CIT avoidance strategy: ParentCo (highly taxed by a state where it has nexus) shifts profits (via royalties, interest, and so forth) to two domestic affiliates (US-HavenCo with no nexus outside a tax haven state and Captive InsuranceCo not subject to CIT) and one ForeignCo.

[4] Twenty-one states either offer only separate filing (Alabama, Arkansas, Delaware, Florida, Georgia, Indiana, Iowa, Louisiana, Maryland, Missouri, North Carolina, Oregon, Pennsylvania, South Carolina, and Tennessee) or offer it as an election (Alaska, Mississippi, Montana, Oklahoma, Virginia, and Vermont). Six states either impose a business activity tax that is an alternative to the CIT (gross receipts taxes and the like) or — inexcusably — impose no business activity tax of any serious moment on corporations (Nevada, South Dakota, and Wyoming).

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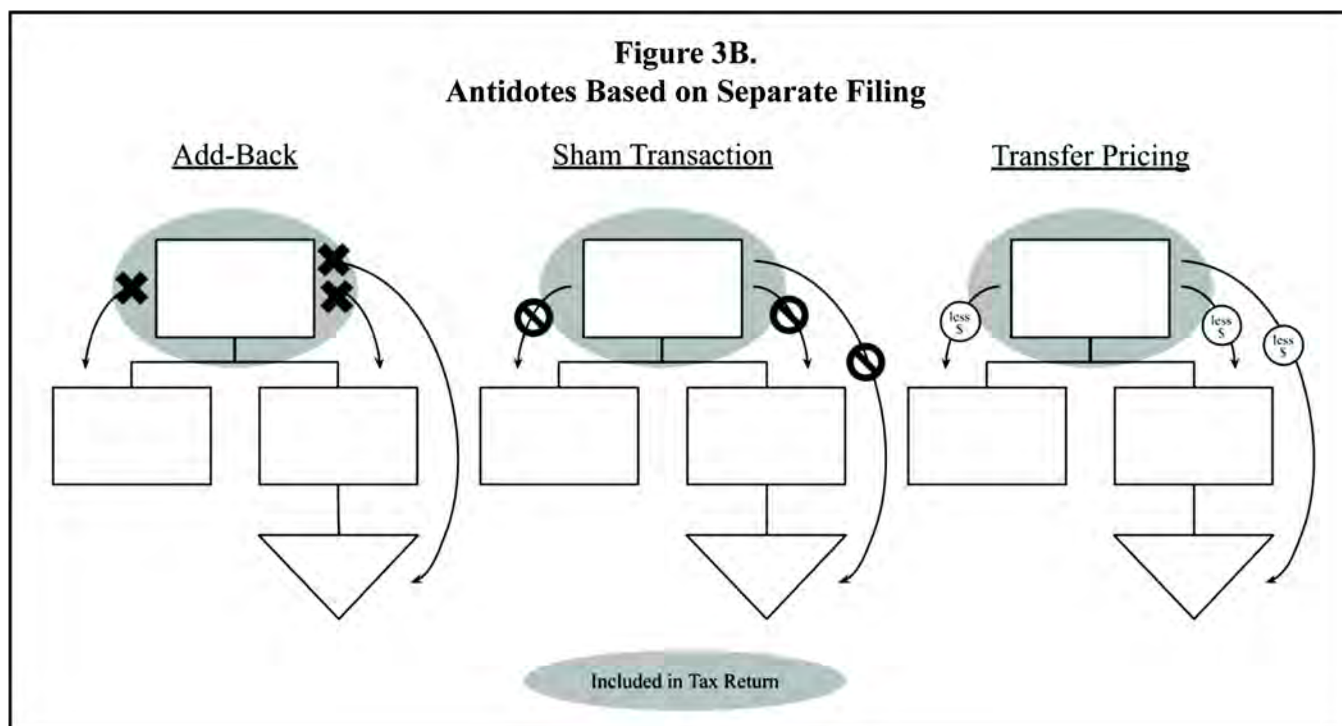

Nexus

Historically, the initial reaction of various separate-filing states to base-shifting tax avoidance was to follow the money. Discovering that some of ParentCo's tax base had been moved (or pretended to have been moved) to US-HavenCo, these states figured they could simply tax US-HavenCo.[5]

CIT avoidance defenders argued that separate-filing states did not possess the jurisdictional authority to impose CIT on US-HavenCo, turning their argument into a constitutional question by analogizing to a couple of Supreme Court cases[6] that barred a state's assertion of sales/use tax (SUT) jurisdiction when a company had no "physical presence" in that state: In the absence of an in-state physical presence (people or property), the connection/nexus between state and company would be insufficient. At great cost and delay, separate-filing state revenue departments battled corporate avoiders in the courts over this issue — did the SUT nexus rule apply as well to CIT? They litigated for 25 years before the Supreme Court changed its mind and ruled that the actual nexus rule for SUT was not physical but "virtual" presence.[7]

Despite the states' significant victory in *Wayfair*, the precise contours of this new standard and its application to CIT reduction strategies could consume more years in the judicial system. More dramatically, as illustrated in Figure 3A, any state effort to assert jurisdiction to tax ForeignCo would be fraught with obstacles, and nexus is simply irrelevant when the company moves its corporate-income-taxable profits to gross premiums taxpayer CaptiveCo.

Alternative Apportionment

Much like rocket missions into outer space, CIT planning strategies often have built-in redundancies.[8] For example, planners often make sure that should a state prevail on nexus, it will find insufficient apportionment (and thus

[5] *See Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E.2d 12 (S.C. 1993).

[6] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *National Bellas Hess v. Illinois*, 386 U.S. 753 (1977).

[7] *South Dakota v. Wayfair Inc.*, 585 U.S. __ (2018).

[8] "Redundancy in Critical Mechanical Systems," NASA, Lesson No. 659 (Feb. 1, 1999).

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insufficient tax base) in the recipient affiliate to get much of any tax revenue out of it. Faced with a strategy pairing nexus insulation with apportionment engineering, many separate-filing states on audit have asserted the "discretionary authority" to change the statutory apportionment rules on a taxpayer-specific basis.[9] Protracted litigation often results, with state victory by no means guaranteed.[10] Figure 3A illustrates this by showing US-HavenCo's "low ETR" in the nexus chart changed to "high ETR" in the alternative apportionment chart.

Addbacks

Eventually, separate-filing states figured they could make an end run around the nexus and apportionment battles by giving up their "follow the money" approach. They shifted their focus away from recipient US-HavenCo and back to the CIT-avoiding entity itself, then simply denied ParentCo's deductions for royalty or interest payments made to affiliates by "adding them back" to income. Addbacks respect the transactions but deny the tax benefits. As illustrated in Figure 3B, addbacks can address a wider set of tax haven entities. Vulnerable to distracting and expensive litigation[11] and narrowly targeting an incomplete suite of CIT reduction strategies (typically addressing only intercompany royalties and sometimes interest), however, statutory addbacks are an inadequate countermeasure.

Sham Transaction Doctrine

Sources of tax law go beyond statutes from the legislature and regulations, rulings, and so forth from the executive. The judicial branch interprets the law; judges are not infrequently criticized for "making new law" as well. That is the American system, carried over from Britain, and it has a name: the common law.

One important common law doctrine that is available for state revenue department use in its antiabuse efforts is the step transaction doctrine, which empowers the state to ignore the various steps in a planner's restructuring scheme and treat all the steps as a single integrated event, disallowing the intended tax reduction. Another is the "sham" doctrine, empowering the state to ignore an entity or a transaction because it is a fake — designed by a planner and implemented by a company but lacking economic substance (business reality) or a primary nontax business purpose.[12]

The sham doctrine may be used by separate-filing states and in combined-reporting states whose filing methods do not embrace all the provisions I recommend below as part of TUCR. Figure 3B shows that, like addbacks, the sham approach neutralizes the planning with CaptiveCo and ForeignCo as well as US-HavenCo. This approach is more flexible than addbacks because it is limited neither to specified transaction types nor by a set of statutory exceptions. It does suffer, however, from the same primary failing as addback challenges: It is highly vulnerable to the resource drain and uncertainty of audit litigation.[13]

Transfer Pricing

"We have basically won," think many companies and their advisers when a revenue department auditor decides to challenge CIT planning by nibbling around the edges of its lost tax base (Figure 3B), quibbling over the correct price for a planner-fabricated transaction.

Much ado has been made over the years regarding a need for states to learn IRC section 482 transfer pricing principles from federal auditors and economists, regarding a role the Multistate Tax Commission might play in improving the quality of state transfer pricing

[9] Such assertions could be based upon the state's adoption of the Uniform Division of Income for Tax Purposes Act section 18, upon analogy to the state's general conformity to the federal IRC and its transfer pricing rules under IRC section 482, upon general common law principles, or upon a variety of other antiabuse statutes. *See, e.g.*, N.C. Gen. Stat. section 105-130.16(6); N.J. Rev. Stat. section 54:10A-10(a).

[10] Andrea Muse, "No Authority for Investee Approach, Attorney Tells Massachusetts High Court," *Tax Notes Today State*, Apr. 8, 2022.

[11] *See, e.g.*, *Surtees v. VFJ Ventures Inc.*, 8 So. 3d 950 (Ala. Civ. App. 2008).

[12] This common law doctrine has been codified in IRC section 7701(o).

[13] *See, e.g.*, *Sherwin-Williams Co. v. Commissioner*, 438 Mass. 71 (2002).

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audits, and regarding allegations that states rely too much on one or another particular transfer price testing method.[14]

But these debates miss the point. The federal government is forced by global circumstances to live in a fantasy world in which the IRS is reduced to accepting as factual the entirely fanciful notion that a multi-entity unitary business does not act like it is under common control. For some unitary multinational or multistate business enterprises, fine distinctions like legal entities and geographic boundaries may be little more than nuisances, to which the C-Suite pays attention only to avoid regulatory (including tax) limitations or to comply with them. From the market perspective, a unitary business generally operates as if it were a single legal entity.

But for opportunities to avoid the unpleasantness of taxation and regulation, such a C-suite would rarely slow down to clutter the company's org chart with scores of specialized legal entities. But for the tax avoidance benefits, that CEO would not allow the "crown jewels" of the company's intellectual property collection to be moved into an Intangibles HoldCo because federal law may limit recovery in an infringement suit to the holding company's sliver of lost royalties rather than the whole group's lost profits. But for the tax benefits, that general counsel may not look away as the chief tax officer "negotiates" written license agreements on behalf of both sides of a fictitious "deal."

My left hand does not negotiate with my right because they're both controlled by the same brain, but federal transfer pricing principles demand that we suspend our rational disbelief. In contrast, multistate CIT principles are more reality based — at least among those tax-mature states that have adopted some form of statutory unitary combined reporting. In the unitary combination environment, the right hand is understood to share the same brain with the left, so hands are disregarded as separate conscious entities, and "transactions" between them are ignored.

U.S. states are privileged to operate within a legal system that recognizes the unitary business principle — the foundation of formulary apportionment and combined reporting — and thus enables the states to conform their corporate income tax systems to modern business realities.[15] Unlike our federal government operating on the global stage, states do not have to rely upon transfer pricing concepts as an antidote to CIT avoidance. They can conform their tax systems to modern business realities; they can adopt TUCR.

Selective Combination

Figures 3A and 3B illustrated five of seven incomplete challenge mechanisms commonly employed by separate-filing states — nexus, alternative apportionment, addbacks, sham transaction, and transfer pricing — and demonstrated their inadequacies. We turn now to Figure 4A, which uses the same generic tax avoidance scheme to illustrate separate-filing states' two primary dalliances with the combination concept in their search for CIT avoidance countermeasures that still fall short of unitary group combination — sham entity and ad hoc combination.

These two selective combination countermeasures can be applied only on audit because they are so taxpayer specific. This stands in marked contrast to TUCR, which is not dependent upon catching a company's planning on audit, but instead neutralizes CIT planning automatically (assuming legal compliance and no tax evasion).

Sham Entity

The common law sham doctrine — discussed above in the context of disregarding a planner's creation of several tax-avoidance-motivated intercompany *transactions* — can be applied as well to NewCo *entities* created by the CIT planner.

[14] *See, e.g.*, Doug Schwerdt, Guy Sanschagrin, and Bill Lunka, "SALT Transfer Pricing — What You Need to Know: Part 1," *Tax Notes State*, Jan. 24, 2022, p. 359.

[15] "The linchpin of apportionability in the field of state income taxation is the unitary business principle" because that principle reflects "the underlying economic realities." *Mobil Oil v. Vermont*, 445 U.S. 425, 439, 441 (1980).

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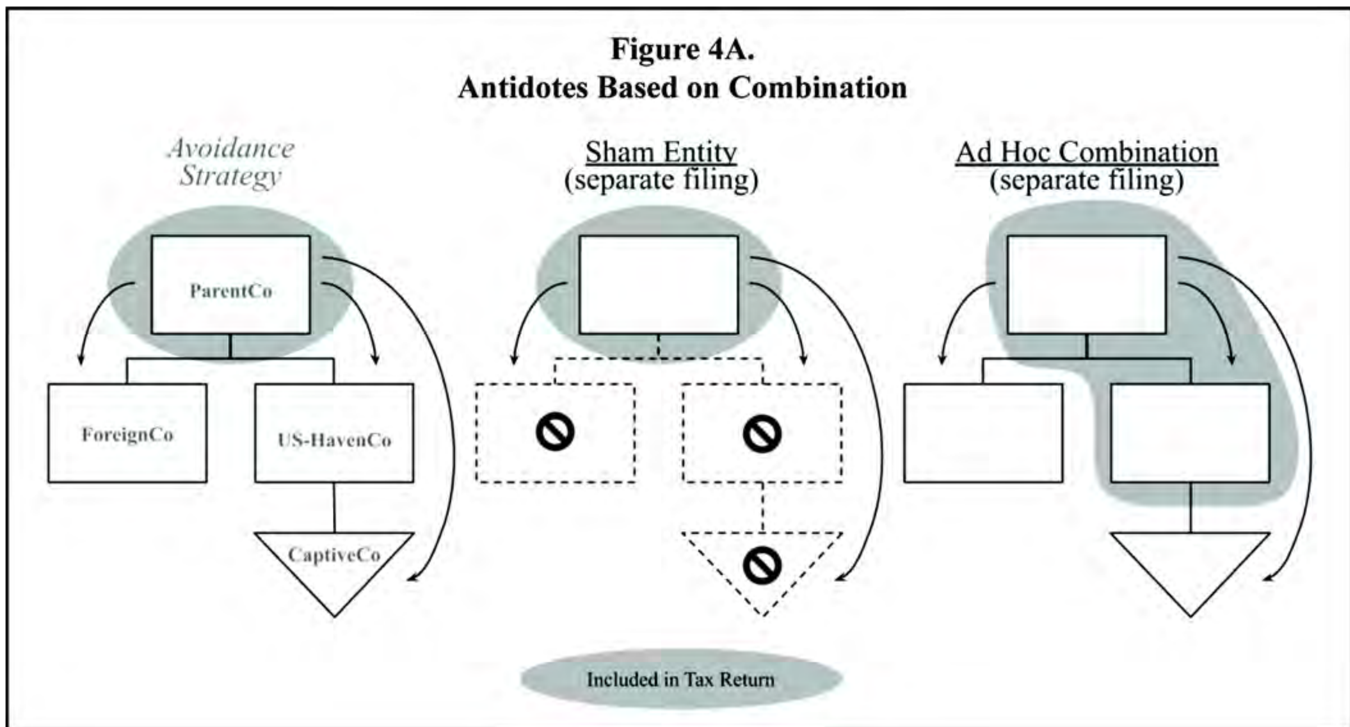

Strictly speaking, this separate-filing state antidote is not a combination method but, as shown in Figure 4A, it achieves the same results. Instead of requiring US-HavenCo, ForeignCo, and CaptiveCo to file a combined report with ParentCo, the state argues that the planner's new entities have no real existence apart from ParentCo. Here, the state analogizes to the avoidance planner's strategy of using a disregarded single-member limited liability company to allow tax base and apportionment factors to flow up (pass through) to the parent as if they were mere divisions of a single legal entity.[16] The state here uses the "disregarded entity" concept in reverse, neutralizing the avoidance.

Or so goes the hope. The common law sham doctrine is vulnerable, as noted above, to the vagaries, expense, and delays of audit litigation. A separate-filing state is barely dipping its toes into combined reporting when it pursues this difficult and litigious path, perhaps inviting more trouble than it is worth. Adoption of TUCR is the better answer.

Ad Hoc 'Cherry-Picked' Combination

This last of the separate-filing state countermeasures, also presented in Figure 4A, may appear to be quite like the first of the unitary combined state antidotes illustrated in Figure 4B, but it differs in two important ways. These differences bear both on the perceived legitimacy of the antidote and on the problems of cost, uncertainty, and delay that plague all the countermeasures attempted by separate-filing states.

First, while water's-edge combination is outlined clearly in statutes that all taxpayers can understand and must follow, the source of authority for ad hoc combination is the same unstable "discretionary authority" upon which states rely for their alternative apportionment antidote, discussed above.[17]

[16] *See* discussion of the apportionment engineering and shelter entity "building blocks" earlier in this series at Griswold, *supra* note 1.

[17] The same imprecise contours of "discretionary authority" that create fertile ground for CIT planners to stymie successful application of the alternative apportionment antidote also afflicts the ad hoc combination counter because it too is rooted in UDITPA section 18, analogy by conformity to IRC section 482, common law principles, and so forth.

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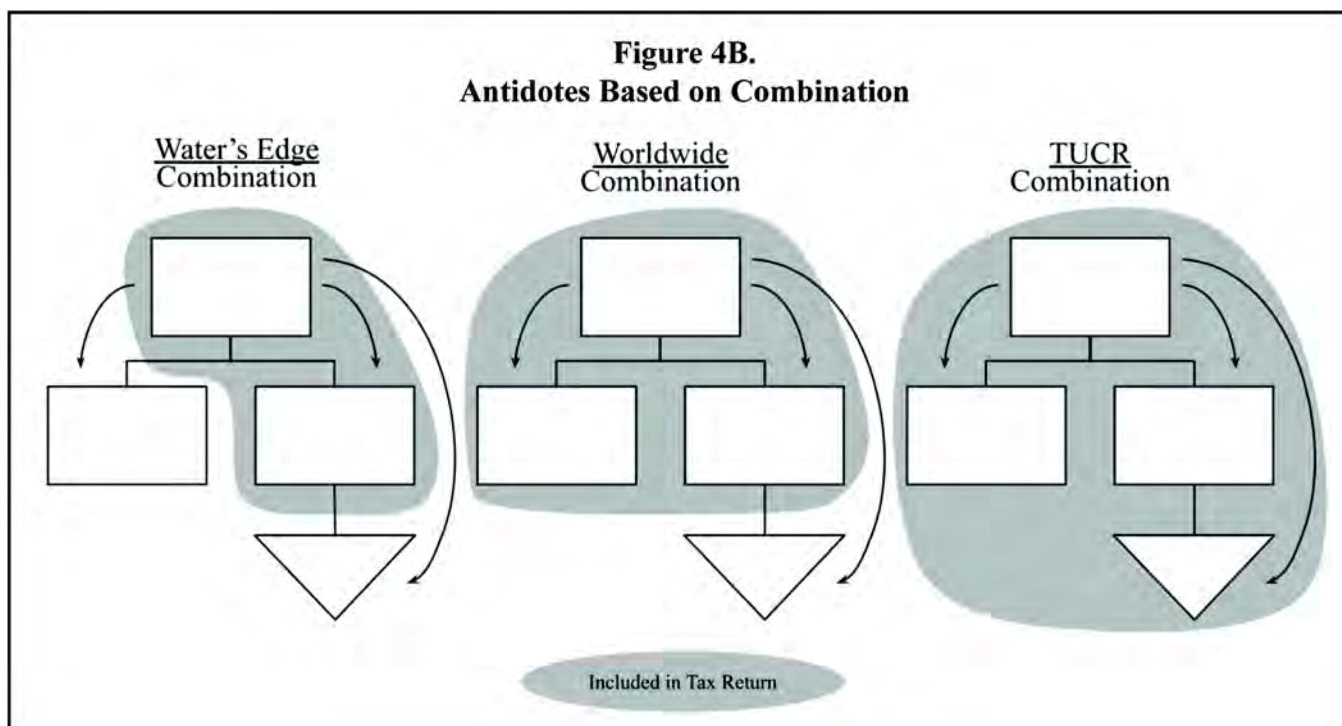
Figure 4B.
Antidotes Based on Combination



Second, like the sham entity antidote, ad hoc combination does not require the state to combine all unitary affiliates as unitary combined states must. (Figures 4A and 4B do not pick up this critical nuance.) In fact, if US-HavenCo has nexus with the separate-filing state, under this countermeasure the state may attempt the unconstitutional task of combining it with ParentCo even if they are not unitary with each other. States employing the ad hoc combination antidote have been accused of cherry-picking only those entities for which combination would increase the state's tax take, while ignoring those that do the opposite.

This concludes the overview of separate-filing states' primary approaches to neutralizing common CIT reduction strategies. The features common to all?

- They are often costly, slow, and ineffective.
- Adoption of any type of unitary combined reporting would solve some of these problems.
- Adoption of TUCR would solve virtually all these problems.

Incomplete Combination

Turning now from separate-filing states (which are highly vulnerable to CIT avoidance) to unitary combined reporting states (where legislators may not appreciate that they too are vulnerable), take a look at Figure 4B. Also based on the same generic CIT avoidance strategy shown in the other figures, Figure 4B illustrates three broad categories of the unitary combined reporting method — water's-edge, worldwide, and TUCR.

Please recall three points from part 1 of this series.[18] First, the "unitary business principle" — constitutionally permitting states to tax a multi-entity unitary enterprise essentially as if it were a single entity — has the advantage (from the economic validity and fairness standpoints) of being consistent with the business reality of how multistate and multinational executives actually operate their businesses. The separate-filing method decidedly does not share that consistency. Second: While the unitary group of a multinational business comprises all its unitary affiliates worldwide, and it is constitutionally

[18] Griswold, *supra* note 1.

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permissible for a state to include them all in a single report,[19] most states today choose by law to combine a smaller group composed only of U.S. domestic entities. For these states, combination stops at "the water's edge."[20] Third: The water's-edge and worldwide methods fail to include some essential enhancements that create TUCR. (These enhancements are elaborated below.)

Figure 4B shows it all: Water's-edge combination neutralizes many domestic CIT reduction strategies, worldwide combination neutralizes a larger but still incomplete set of strategies, and TUCR neutralizes them all.

Water's-Edge Unitary Combination

Unitary combined reporting — even when inclusion in that group stops at the water's edge — is superior to every countermeasure that a separate-filing state can throw at a CIT planning problem. Water's-edge combination escapes much of the litigation that plagues all the separate-filing states' antidotes.[21] It is the dominant method of combined reporting in the country today, perhaps because of significant lobbying by corporate interests against worldwide combination, which neutralizes CIT avoidance that piggybacks on federal avoidance, while water's edge does not.

Despite its superiority to separate-filing countermeasures, water's-edge combination has serious flaws. Figure 4B demonstrates the problem graphically: The water's-edge rule — excluding both foreign affiliates and entities whose business activities are taxed with reference to a tax that is based on something other than net income — leaves a great many tax avoidance strategies unimpeded.

Rifle-shot attempts to move a water's-edge method incrementally toward worldwide — like "tax haven blacklist" laws that include in the combined report net income from enumerated countries widely understood to be hosts of significant tax shelter activity (like the Bahamas, Belize, Bermuda, the British Virgin Islands, Ireland, Netherlands, Switzerland, and more) — are inadequate stopgap methods that will always leave states steps behind the "catch me if you can" CIT avoiders.

Water's-edge unitary combination states are still vulnerable to the planners' innovations. Their legislatures would protect the public fisc much more effectively if they would just adopt TUCR.

Worldwide Unitary Combination

Figure 4B makes worldwide unitary combination look a lot more effective than water's-edge combination because it is. Worldwide combination (elimination of the water's-edge election) brings into the tax return the tax bases and apportionment factors of all unitary group members in most types of industries, regardless of their location. As noted in part 1 of this series, state CIT calculations of the tax base for a company typically begin with its federal tax base. That means the company's federal tax avoidance strategies — which typically include moving tax base out of the United States and into tax haven jurisdictions around the globe, often through highly complex maneuvers involving many fabricated legal entities and transactions overseas — are baked into its CIT starting point calculations.

State CIT planners piggyback in a significant way on the work of their federal tax planning colleagues. Based on data analysis by the Institute on Taxation and Economic Policy and the U.S. PIRG Education Fund, a whopping $14 billion of the $17 billion in tax revenue lost annually by the states to CIT avoidance is due to this federal tax avoidance piggyback.[22] Water's-edge states that congratulate themselves for having smarter tax policy than separate-filing states ought not to rest on their laurels, because water's-edge combination closes less than 20 percent of the avoidance loophole, compared with worldwide combination states. But worldwide unitary

[19] *Barclays Bank v. California*, 512 U.S. 298 (1994); *see also Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983).

[20] It stops at the land borders with Canada and Mexico as well, but we get the point.

[21] This is not to say that big dollar unitary state CIT issues have not been slogged out in court; they have. Aggressive tax return "filing" positions or refund claims are produced by the same CIT planning innovators who develop proactive structural planning. *See, e.g.*, *Microsoft v. California*, 39 Cal. 4th 750, 139 P.3d 1169, 47 Cal. Rptr.3d 216 (2006); *General Mills v. California*, 146 Cal. Rptr.3d 475 (Ct. App. 2012). However, these issues appear to be far more "out in the open" than those produced by the proactive structural planning that is the focus of this series of articles.

[22] *See* the Institute on Taxation and Economic Policy, *supra* note 2, at 2.

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combined reporting is rare. Furthermore, even this improved method still leaves open some gaping avoidance holes. These are addressed in the third unitary combined filing method discussed in this article, TUCR.

Best Antidote: True Unitary Combined Reporting

Take a look back at figures 4A and 4B and you will observe a conceptual progression — from a fully vulnerable separate-filing state dipping its toe into combination by "shamming" some entities, to the potentially unconstitutional ad hoc combination approach, to water's-edge (domestic) unitary combination, to worldwide unitary combination, and finally to an enhanced worldwide unitary combination method that is truly complete — TUCR.

To maximize states' defenses against the CIT planning industry, I propose that every state adopt TUCR. It is not enough for the states to adopt traditional worldwide unitary combination because that approach — depending upon the details of the state's statutes or upon the vagaries of common law court decisions — would leave open five significant CIT avoidance-enabling gaps:

- the water's-edge election;
- the nonconforming industry exclusion;
- the "80/20" back door;
- the "nowhere income" phenomenon; and
- the combined-but-still-separate method.

TUCR resolves four of these five problems with:

- real worldwide combination;
- multi-industry combination;
- 80/20 elimination; and
- throwback sales-factor apportionment.

I have not recommended that TUCR include a fifth strengthening provision — "single taxpayer" unitary combination — out of a concern that the long-simmering "*Finnigan* rule or *Joyce* rule" controversy may need even more time to develop before such a proposal could gain traction.[23]

Figure 4B illustrates the first two enhancements made by TUCR: its inclusion of all unitary affiliates — regardless of geographic location or industry specialization — in the combined return.

Real Worldwide Combination

Not a single state today actually provides a combination method that always includes, for all types of CIT payers, unitary affiliates across the globe. Most states provide only for water's-edge combination, Alaska requires worldwide combination only for a specific industry and some noncompliant taxpayers,[24] and a handful of states (incredibly) provide taxpayers with a get-out-of-CIT-free card — the opportunity to choose whichever method produces the smallest amount of tax.[25]

Such elections — between separate filing and combined reporting or (in unitary states) between water's-edge and worldwide reporting — are ignominious examples of poor state tax policy. These elections allow a planner to develop CIT reduction strategies for each method, model the results, and then elect whichever filing method escapes the most tax. These elections, which have been passed by state legislatures and signed into law by governors, take voluntary vulnerability to new lows.

Water's-edge combination is an invitation for CIT planners to piggyback on their federal tax planning colleagues' schemes and add more of their own. TUCR puts an end to this vulnerability, providing for just one filing method — worldwide unitary combination.

Multi-Industry Combination

When it comes to inclusion of appropriate entities, however, geography is not the only potential get-out-of-CIT-free card that TUCR takes away from CIT avoiders. Industrial specialization is also at play.

The vulnerability here is state CIT statutes that — for good or bad policy reasons (we need not address that question here) — create industry-specific departures from the usual CIT rules for business activity taxes. A business enterprise may include some entities (fabricated by avoidance

[23] *See* Griswold, *supra* note 1, fn. 6.

[24] Alaska Admin. Code 15 section 20.100(a).

[25] *See, e.g.*, Cal. Rev. & Tax Cd. Section 25101; D.C. Code Ann. section 47-1810.07(b); Mass. Gen. L. section 32B(c)(3).

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planners or essential to real operations) that are not subject to the CIT, or that are subject to CIT under specialized rules, according to industry-based distinctions. Some types of business entities may be subject in some states to different tax bases (bank excise taxes[26] or insurance premium taxes,[27] for example). Or perhaps they are CIT payers but are provided with apportionment rules that differ from those for most industries (railroads or telecommunications companies, for example).[28]

When otherwise combinable unitary entities in a particular industry are subject to a non-CIT base or to nonstandard apportionment rules, the difficulty of figuring out how to combine them may cause some states to take the easy (but ultimately costly) way out, throw up their metaphorical hands, give up on the unitary combination principle along with its antiabuse benefits, and exclude entities in these industries from the combined group. The difficulty of making adjustments to tax base or apportionment rules, however, is no justification for not doing it. Much thornier tax issues have been addressed and resolved by smart people in state legislatures and revenue departments. A failure to figure this out would be a failure of governmental obligation to citizens.

TUCR includes all unitary affiliates, regardless of specialized industry, in the combined group. This is illustrated in Figure 4B by inclusion of CaptiveCo in the TUCR combined group. The following two features of TUCR are not reflected in Figure 4B.

80/20 Elimination

Three decades ago, a few water's-edge unitary combination states were persuaded to carve a back door into the combined group edifice, allowing any domestic legal entity with 80 percent or more of its property and payroll outside the United States (and thus 20 percent or less within the United States) to be excluded from the water's-edge combined group.[29] There was no genuine policy reason for the rule; it was sought and obtained by lobbyists seeking a back door through which CIT planners could transport tax base out of the state's reach. Sixteen states today offer CIT planners the 80/20 back door, making these states knowing hosts of a tax haven that impoverishes their own citizens. TUCR closes this back door.

Throwback

In part 1 of this series, I explained that "analogizing a corporation's tax base to a pie, apportionment addresses how big a slice is portioned out to each state that has jurisdiction to tax it."[30] Returning to this metaphor, one of the goals of CIT planners is to leave some of the pie on the plate untaxed anywhere. Recall from the avoidance-planner's CIT primer[31] that the size of the slice to which any one state is entitled will be determined by formulary apportionment, which may or may not include property and payroll factors but always includes a sales factor. The sales factor for a state is calculated as a fraction whose numerator is sales sourced to the state (because the company's customers are located there) and denominator is all sales everywhere.

The planner's goal in this case (leaving some pie untaxed on the plate) has been well described as the creation of "nowhere income." The planner achieves this goal by structuring the selling affiliate in a way that it is not subject to tax in some of the states where its customers are located. To do this, the planner uses the "nexus insulation" building block described in part 1, perhaps aided by the federally created jurisdictional safe harbor of Public Law 86-272.

If the whole pie is the taxpayer's total sales everywhere, then the slice left untaxed on the pie plate is nowhere income; the CIT-planning company takes it home, sharing some of it with the planner as a fee. The nationwide public is entitled to tax the entire pie; the only issue should be which states get how big a slice. This is where the "throwback" rule comes in. The state from which the goods are sent out to the customer (the "origin" state) is entitled to "throw back" to its

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[26] *See, e.g.*, 32 V.S.A. section 5836 et seq. (Vermont).

[27] *See, e.g.*, Conn. Gen. Stat. section 12-201 et seq.

[28] *See, e.g.*, Va. Code Ann. section 58.1-420(A); Va. Admin. Code 23 section 10-120-270.

[29] *See, e.g.*, Bruce J. Fort, "Anatomy of a Domestic Tax Shelter," *Tax Notes State*, May 17, 2021, p. 689.

[30] Griswold, *supra* note 1.

[31] *Id.*

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numerator the sales made into states ("destination" states) that do not possess the jurisdiction to impose CIT on the company but would if they could.[32]

Throwback sales-factor-apportionment sourcing prevents corporations from generating nowhere income by ensuring that the worldwide apportioned share of its taxable income is 100 percent, or close to it.[33] TUCR includes this rule.

Conclusion

State legislatures that leave unreformed their separate-filing or incomplete unitary combination regimes victimize their own citizens. Despite the variety of piecemeal countermeasures discussed above, these inadequate CIT filing methods are littered with gaping holes. Each year, large multinationals exploit those holes to shift $17 billion in tax obligations[34] from wealthy shareholders onto small businesses that pay their fair share, and ultimately onto the working class and the poor when other taxes — particularly consumption taxes that fall most heavily on these groups — are increased to cover CIT shortfalls.[35] Also, the avoiders force reductions in public services that the people have demanded at the ballot box.

TUCR would put an end to avoiders' industrial-scale reductions of CIT revenue if all states would adopt it. Avoidance normalizers can be expected to resist TUCR, just as they have resisted calls for less complete unitary combined filing laws that would make state filing methods more inclusive, complete, fair, and reflective of business reality.[36] TUCR would deny these interests the power to continue draining the public fisc to the detriment of the public. State adoption of TUCR would neuter most CIT avoidance, improve tax fairness, bring in balanced tax revenue, and increase voluntary compliance as taxpayer perceptions of improved fairness increase.

In the event that policymakers need more evidence of the enduring advantage possessed by avoiders — an advantage that only TUCR can reverse — the remaining articles in this series will explain and illustrate a wide range of CIT avoidance strategies and their ability to mutate in response to state antidotes. Using only public information about specific planners and avoiders, I will name names. Next up: the aging but still widespread "siphoning" family of CIT avoidance strategies, including naked, natural, and turbo-charged holding companies of various stripes, and more. ■

[32] *See*, *e.g.*, Ark. Code Ann. section 26-51-716.

[33] Sales would not be thrown back if they were made to a destination state that does not impose a CIT.

[34] The Institute on Taxation and Economic Policy, *supra* note 2.

[35] *See* Griswold, "Efficiency vs. Equity in COST's Consumption Tax Study," *Tax Notes State*, Apr. 25, 2020, p. 425.

[36] *See*, *e.g.*, Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Council On State Taxation (May 2008).

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