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In this installment of A Pinch of SALT, the authors describe 80/20 rules used by states in the context of water's-edge combined reporting and the compliance issues that can arise as a result.

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## I. Introduction

The unitary combined reporting method for state corporate income taxation has been adopted by an increasing number of states.[1] While combined reporting requirements vary significantly from state to state, nearly all combined reporting regimes require or allow a water's-edge method that limits the members of a group return to entities that are incorporated in the United States and meet other combined reporting requirements. The water's-edge combined reporting method makes sense for many taxpayers and stems from criticisms and litigation aimed at the worldwide combined reporting method. Problems with worldwide combined reporting include compliance challenges associated with varying accounting methods required by other countries, conversion of foreign currencies, and even the lack of available data associated with non-U.S. entities.[2] Limiting unitary combined reporting to domestic affiliates mitigates these problems.

Is characterizing an entity as domestic or foreign solely based on its place of legal incorporation a sensible method to include or exclude it from a water's-edge (domestic) combined report? Often it is. But there are instances when a foreign-incorporated entity engages in substantial business in the United States. Alternatively, there are instances when a domestic incorporated entity is largely engaged in business outside the United States. To help solve this problem, many states adopted the Pareto principle, which states that "for many outcomes, roughly 80 percent of consequences come from 20

[1] *See* Michael J. Bologna, "'Sham Transactions' Trigger States to Crack Down on Tax Havens," Bloomberg Tax, Feb. 26, 2021.

[2] *See* Jerome R. Hellerstein, Walter Hellerstein, and Andrew Appleby, "Legislation Restricting Worldwide Combined Reporting," *State Taxation*, at para. 8.18.



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percent of causes (the 'vital few')."[3] Application of an 80/20 rule in the context of water's-edge combined reporting requires taxpayers to include in a water's-edge return those foreign entities that conduct at least 20 percent of their business in the United States (an inbound 80/20 company), and exclude those domestic corporations that conduct at least 80 percent of their businesses outside the United States (an outbound 80/20 company). This installment of A Pinch of SALT describes different 80/20 company approaches used by the states, and issues that arise.

## II. So, What Is an 80/20 Company Anyway?

Since the adoption of water's-edge combined reporting, questions have arisen as to how to best classify a domestic entity.

States have applied a simple rule defining water's-edge entities as those incorporated in the United States. Thus, the most rudimentary rule for including a member in a water's-edge report asks only whether it is incorporated in the United States. If the answer is yes and the entity is unitary with other report-filing members, then it is included in the report. If the answer is no, then the entity is excluded. This rule is easy to follow and administer. But it fails to account for cases in which, despite an entity's place of incorporation, it might still be considered domestic. In answering the (perhaps metaphysical) question "what is a domestic entity?" some states look beyond the place of incorporation.

An 80/20 company is just a nuanced answer to that question.

### A. Domestic and Foreign 80/20 Companies, Generally

Some domestically incorporated entities might not be considered truly domestic if, say, they do most of their business outside the United States. From a policy perspective, these domestic 80/20 companies should be excluded from the water's-edge combined group. In defining an excluded domestic 80/20 company, states generally look to an average of the entity's payroll and property located in foreign jurisdictions. For example, Colorado, Illinois, and New Hampshire require an average of foreign property and payroll factors to meet the 80 percent threshold. New Jersey requires that both foreign property and payroll factors independently meet the 80 percent threshold.[4]

On the other hand, entities that are foreign incorporated might in substance be domestic if they engage in a given level of domestic business. For the same reason a domestic 80/20 company may be *excluded* from a water's-edge combined report, these foreign 80/20 companies may be *included* in the water's-edge combined report. Although some states look to an average of a domestically incorporated entity's payroll and property factors to determine whether it is an 80/20 company, a handful of states (California, Massachusetts, and the District of Columbia, for example) *also* look to an entity's sales factor (in addition to property and payroll factors) when determining whether the entity is a *foreign* 80/20 company.[5]

Thus, the general — but by no means uniform — rule excludes domestic 80/20 companies as those that are domestically incorporated and have an average of at least 80 percent of their payroll and property located in foreign jurisdictions.[6] And the general rule includes in a water's-edge combined group foreign 80/20 companies — those that are foreign incorporated and have an average of at least 20 percent of their property, payroll, *and* sales in the United States.

### B. The Spice of Life: Variations on the General Rule

There are variations of defining exceptions to water's-edge group membership that do not look to property, payroll, or sales factors. Michigan and Wisconsin exclude from a water's-edge group domestic incorporated entities whose "active

[3] *See* Wikipedia, "Pareto Principle."

[4] N.J. Rev. Stat. section 54:10A-4.11(a)(1) (providing that a water's-edge return includes all unitary domestic members, except for "such a member if eighty per cent or more of both its property and payroll during the privilege period are located outside the" United States).

[5] *See, e.g.*, D.C. Code Ann. section 47-1810.07(a)(2)(B); Cal. Rev. & Tax. Code section 25110(a)(1)(B); Mass. Gen. Laws ch. 63, section 32B(c)(3).

[6] *See, e.g.*, 35 Ill. Comp. Stat. 5/1501(a)(27)(A) (excluding "members whose business activity outside the United States is 80 percent or more of any such member's total business activity" from the unitary group); Ill. Admin. Code tit. 86, section 100.9700(c)(1), (c)(2)(B) (providing that entities must determine whether 80 percent or more of their total business activities are outside the United States by averaging their property and payroll factors outside the United States).



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foreign business income" is at least 80 percent of total income.[7] Wisconsin defines "active foreign business income" as "gross income derived from sources outside the United States, as determined by subchapter N of the Internal Revenue Code, including income of a subsidiary corporation, and attributable to the active conduct of a trade or business in a foreign country or in a U.S. possession."[8] Michigan ties its definition of "active foreign business income" to IRC section 861(c)(1)(B) (now IRC section 871(*l*)(1)(B)(ii)).[9]

## C. You Want Me to Do What Now? (Compliance Issues)

While variety may be the spice of life, it usually just means more work when it comes to tax compliance. State auditors are on the lookout for entities that should be included or excluded from a combined report because group composition changes both the tax base and apportionment factors. And depending on the mix, state rules could result in tax deficiencies.

Compliance gets even more complicated when layering on the expense addback or disallowance rules. Illinois requires taxpayers to add back deductions for "interest expenses and intangible expenses incurred in transactions with a person who would be a member of a unitary business group with the taxpayer, if not for the 80/20 test."[10] Not only do taxpayers have to keep an eye out for foreign entity apportionment factors, but they also need to monitor the source of deductions and costs paid to foreign entities.

Perhaps the most prevalent compliance challenge associated with 80/20 treatment stems from the fact that many states have abandoned the use of property and payroll apportionment factors even though these same states may require property and payroll calculations for 80/20 testing. California adopted a single-sales-factor apportionment formula in 2013 for most taxpayers, but its water's-edge rule continues to require the inclusion of any entity whose average property, payroll, and sales factors in the United States is at least 20 percent.[11] This means that taxpayers must compute the property and payroll factors of foreign entities just for purposes of monitoring compliance with its 80/20 rules.[12]

## D. Tax Planning and Recent Controversies

Not surprisingly, the application of 80/20 rules can lead to controversies.

For example, in *PepsiCo*, the Illinois Tax Tribunal analyzed the amount of substance required for entities to qualify as an 80/20 company.[13] PepsiCo Inc. sought to exclude from its water's-edge combined group a single-member limited liability company (SMLLC) that it claimed was an 80/20 company. This SMLLC was used to employ U.S. expatriates who were on temporary foreign assignment.[14] The tribunal noted that although Illinois's 80/20 test involves a mechanical calculation, "it is hardly a stretch to accept that the Department can look behind such determinations to review the appropriateness of any such claim."[15] The tribunal applied a common law employment test to determine that the SMLLC was not the employer of the expatriates, but was a "shell corporation" that must be disregarded.[16] Consequently, the subsidiary did not have adequate foreign payroll to qualify as an 80/20 company.[17]

In a 2019 case involving Exxon Mobil, Montana's Supreme Court considered a decision by the state's Department of Revenue to allow only an 80 percent deduction of dividends received from 80/20 corporations.[18] The court concluded that the corporation was entitled to a 100 percent deduction for dividends received

[7] *See, e.g.*, Mich. Comp. Laws Ann. section 206.607(3) (providing that a foreign entity includes a domestic company if it has "substantial operations" outside the United States and "at least 80 percent of its income is active foreign business income"); Wis. Stat. section 71.255(2)(c)(1).

[8] *See* Wis. Stat. section 71.255(2)(c)(2).

[9] *See* Mich. Comp. Laws Ann. section 206.607(3)(c).

[10] Ill. Admin. Code tit. 86, section 100.2430(a).

[11] *See* Cal. Rev. & Tax. Code section 25110(a)(1).

[12] *See* California Franchise Tax Board, Water's Edge Manual at "Chapter 2: Water's-Edge Combined Report" (undated).

[13] *PepsiCo Inc. v. Department of Revenue*, 16 TT 82 (Ill. Tax. Trib. 2021).

[14] *Id.* at 1-2.

[15] *Id.* at 12.

[16] *Id.* at 22-23.

[17] *Id.* at 34-35.

[18] *Exxon Mobil Corp. v. Department of Revenue*, 444 P.3d 407, para. 1 (Mont. 2019).



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from its 80/20 subsidiary because the Legislature had not expressly provided otherwise.[19]

Finally, Colorado courts issued two decisions regarding forced combination of 80/20 companies. When those decisions were issued, Colorado law provided that a foreign-incorporated entity is not included in a Colorado combined report unless more than 20 percent of its property and payroll was within the United States — such corporation is denominated an "includable C corporation."[20] Colorado law also provided (and still does) that the executive director of the Department of Revenue has discretionary authority to allocate the gross income and deductions between or among two or more commonly controlled C corporations (whether domestic or foreign) in order to clearly reflect income.[21]

In *Agilent Technologies*, the Colorado Supreme Court determined that the state's DOR could not include in a combined group an entity that failed to satisfy the 20 percent property and payroll thresholds even under the agency's discretionary authority to reallocate income. In *Agilent*, the taxpayer excluded from its water's-edge combined return a domestically incorporated, wholly owned subsidiary that served as a holding company named World Trade.[22] World Trade owned no real or tangible personal property and had no employees, but it owned stock in four foreign subsidiaries that operated outside the United States.[23] World Trade received significant dividends on its shares of the foreign subsidiaries, which the DOR sought to tax by including World Trade as a member in the water's-edge combined income tax return.[24] The court observed that to be includable as a member of a Colorado combined income tax return, an entity must be an "includable C corporation" — it must have more than 20 percent of its property and payroll factors assigned to locations in the United States. Since World Trade had no property or payroll, it was not an includable C corporation.[25] Nor could the DOR exercise its discretionary authority to include World Trade as a member of a combined return. The court explained that authorizing that end run around the combined group membership rules would render them meaningless. Thus — and rightly in our view — the court concluded that the DOR was not authorized to include World Trade in a combined report with its parent company.

On the same day *Agilent* was decided, the court handed down another opinion dealing with the 80/20 regime. In *Oracle Corp.*, the Colorado Supreme Court again held that a domestically incorporated holding company with no payroll or property could not be included in a water's-edge combined report.[26] The holding company in *Oracle*, OJH, sold millions of shares of stock on the Tokyo Stock Exchange, recognizing billions in capital gains.[27] OJH was formed under the terms of a secured loan between Oracle and Nippon Steel, an unaffiliated Japanese entity.[28] As in *Agilent*, the DOR attempted to include OJH in Oracle's combined return. In a brief opinion, the court noted that the DOR made the same arguments as in *Agilent* and rejected them for the same reasons as stated in *Agilent*.[29]

### III. Conclusion

Location of legal incorporation is an easy-to-administer rule for determining whether an entity is foreign or domestic for purpose of inclusion in a water's-edge combined return. However, there are instances in which it makes sense to include or exclude entities in a water's-edge return regardless of their place of incorporation. While 80/20 rules help fill in the gaps, they create opportunities for compliance frustrations and controversies. We predict that more states will embrace 80/20 rules and taxpayers will become more familiar with them. And this application of an 80/20 rule will serve as a classic example of the Pareto principle. ■

[19] *Id.* at paras. 8-30.

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

[21] Colo. Rev. Stat. section 39-22-303(6).

[22] *Department of Revenue v. Agilent Technologies Inc.*, 441 P.3d 1012, 1014 (Colo. 2019).

[23] *Id.* at 1015.

[24] *Id.*

[25] *Id.* at 1017.

[26] *Department of Revenue v. Oracle Corp.*, 441 P.3d 1021 (Colo. 2019).

[27] *Id.* at 1022.

[28] *Id.*

[29] *Id.* at 1024-1025.



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