

80/20 Companies: Dispelling Common Misconceptions

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In this installment of A Pinch of SALT, a follow-up to an earlier installment, the authors look more closely at 80/20 companies and

examine three common misconceptions about them.

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Introduction

This A Pinch of SALT column is a follow-up to our January 2023 piece focusing on 80/20 companies.¹ Our prior article provided an overview of the 80/20 company concept, the various approaches states take in defining the parameters of an 80/20 company, and some of the compliance challenges and recent litigation that has arisen involving these companies.

In this installment, we dive deeper into 80/20 companies, examine three common misconceptions about them, and address why each misconception is unwarranted.

A Brief Recap: What Are 80/20 Companies?

Determining whether an entity should or should not be included in a water's-edge combined group is a critical step in preparing any taxpayer's state unitary combined income tax return. The notion of "water's edge" seems obvious at first — only include corporations that are incorporated in the United States. However, several states deviate from looking only to whether a corporation is domestically incorporated — enter the 80/20 rule.

An 80/20 rule requires the inclusion in a combined water's-edge return of those foreign-incorporated entities that conduct at least 20 percent of their businesses in the United States (an inbound 80/20 company) and the exclusion of those domestic-incorporated entities that conduct at least 80 percent of their businesses outside the United States (an outbound 80/20 company). This approach represents a nuanced answer to the

¹Jeffrey A. Friedman, Cyavash N. Ahmadi, and Laurin E. McDonald, "Water's-Edge Combined Reports and 80/20 Companies," *Tax Notes State*, Jan. 30, 2023, p. 405.

question of how to define what constitutes a domestic or foreign entity for purposes of state water's-edge combined reporting.

States often use an average of a company's property and payroll factors to measure business activity for the 80/20 rule. For example, Illinois requires an average of property and payroll factors to meet the 80 percent threshold.² Other states, such as Alaska, use variations that also include the sales factor.³ Some states use a completely different version of the 80/20 test. For example, Wisconsin excludes corporations from its water's-edge combined report "if 80 percent or more of a corporation's worldwide income is active foreign business income."⁴ While there may be differences among the various 80/20 requirements, each is intended to justify the inclusion or exclusion within a water's-edge return based on substance rather than form.

But the well-intended purpose of 80/20 rules has not forestalled criticism. Here, we highlight and respond to three common misconceptions.

Misconception #1: U.S.-Incorporated 80/20 Companies Should Be Included in a State's Water's-Edge Group Because They Are Domestic for Federal Purposes

One of the most frequently advanced criticisms of the outbound 80/20 company exclusion rests on the observation that domestically incorporated corporations are subject to federal income tax and are generally included in a federal consolidated return. Critics argue that because the IRC treats outbound 80/20 companies as domestic, and because states derive their tax bases by conforming to the federal computation of taxable income, there is no reason for states to treat these entities as non-U.S. corporations.

² 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).

³ Alaska Stat. section 43.20.145(a)(1) (including in the water's-edge combined group "an affiliated corporation eligible to be included in a federal consolidated return . . . if the corporation's property, payroll, and sales factors in the United States average 20 percent or more").

⁴ Wis. Stat. section 71.255(2)(c); Wis. Admin. Code DOR section 2.61(4).

This argument, however, is largely driven by form rather than substance. The premise that federal domestic status should dictate state combined group inclusion conflates two fundamentally different tax systems operating on distinct principles and with different jurisdictional constraints.

The federal consolidated return includes affiliated domestic corporations that are linked by 80 percent or more common ownership. A state unitary combined group, by contrast, generally includes corporations that share 50 percent or more common ownership and are engaged in a unitary business. Because these criteria differ — for example, the ownership thresholds, the unitary business requirement, and the treatment of foreign entities — the composition of a federal consolidated group and a state's water's-edge combined group will frequently differ. Treating federal domestic status as dispositive for state combined group membership unnecessarily mixes the differently structured filing regimes.

Unlike the federal government, whose taxing power extends to all income of domestic corporations wherever earned, state taxing authority is constrained by the commerce clause of the U.S. Constitution. The commerce clause, in part, requires that a state tax be fairly apportioned and fairly related to the services provided by the state. Because of these constitutional constraints, a state may not overreach its jurisdiction and tax income that is not fairly apportioned or fairly related to the taxing state. The mere fact that all of an entity's income is subject to federal tax (because that entity is included in a federal consolidated return) does not automatically mean that it is also subject to state tax (because that income may not constitutionally be within a state's taxing authority). The 80/20 company exclusion thus serves a principled function: It helps ensure that the water's-edge group accurately captures entities with genuine domestic business activity.

Recent Colorado legislation may put this misconception to the test. On June 3 Gov. Jared Polis (D) signed H.B. 26-1289, which eliminates the mandatory 80/20 company exclusion for domestic corporations, effective for tax years beginning on or after January 1, 2027. The bill effectively establishes a version of worldwide

combined reporting as Colorado's default filing method by requiring all affiliated C corporations that are members of a unitary business, wherever incorporated or domiciled, to be included in a combined report.⁵

Critically, however, the legislation preserves a water's-edge election.⁶ Members of an affiliated group required to file a combined report may elect water's-edge treatment, but the scope of the water's-edge group is notable for what it does and does not include. Under the election, the water's-edge group includes every member incorporated in the United States or formed under the laws of any state, without regard to the location of that member's property and payroll.⁷ The election does not preserve an outbound 80/20 exclusion: A domestic corporation with 80 percent or more of its property and payroll outside the United States must still be included in the water's-edge combined group. The election, however, includes inbound 80/20 companies, as it requires the water's-edge combined group to include foreign members whose property and payroll assigned to U.S. locations equals or exceeds 20 percent.⁸

This "heads I win/tails you lose" approach puts the first misconception squarely to the test. By requiring all domestically incorporated members to be included in the water's-edge group regardless of their foreign operations, the election eliminates the very protection that the outbound 80/20 company exclusion was designed to provide. The water's-edge election retains the inbound 80/20 concept, pulling in foreign entities with sufficient U.S. activity, but it does not offer a reciprocal exclusion for domestic entities with predominantly foreign activity. Whether this asymmetry will invite challenges or simply shift the compliance landscape for multinational taxpayers operating through U.S.-incorporated entities with substantial foreign operations remains to be seen.

Misconception #2: 80/20 Companies Facilitate Profit Shifting and Erode the State Tax Base

A second misconception is that 80/20 companies are merely a tool to shift income away from domestic state taxation. That narrow view may in part be informed by outlier situations and one-off court decisions.

For example, the Illinois Appellate Court recently affirmed a trial court determination that a single-member limited liability company formed to employ U.S. expatriates working abroad, whose operating attributes flowed up to an affiliate for tax purposes, lacked economic substance and was not the true common-law employer of the expatriates.⁹ The court's holding precluded exclusion of the affiliate from its Illinois return under the state's 80/20 company rule. The court applied the economic substance doctrine and went so far as to find that the affiliate owned no property, had no bank account, operated at a loss, and served merely as a conduit for the exchange of labor between related entities at cost, holding that the 80/20 company rule is "to be strictly construed" with "doubts concerning the applicability" resolved "in favor of taxation."

Such a case, however, does not demonstrate that 80/20 company rules should be cast aside. Rather, it illustrates that existing tools are available to address outlier situations in which an 80/20 company rule may lead to an incorrect result — much like alternative apportionment. States have meaningful mechanisms, including antiabuse doctrines, to address potentially distortive results on a case-by-case basis. An outlier scenario is not a justification to do away with an 80/20 company rule.

Typically, 80/20 rules elevate substance over form. Eliminating the 80/20 company rule would force all domestically incorporated corporations with predominant foreign business activity into a state's water's-edge combined group regardless of whether any profit-shifting concerns that motivate this criticism are present.

⁵ Colo. Rev. Stat. section 39-22-303(11.5).

⁶ Colo. Rev. Stat. section 39-22-303(8.5).

⁷ Colo. Rev. Stat. section 39-22-303(8.5)(b)(I)(A).

⁸ Colo. Rev. Stat. section 39-22-303(8.5)(b)(I)(B).

⁹ *PepsiCo Inc. v. Department of Revenue*, 281 N.E.3d 468 (Ill. App. Ct. 2026).

Misconception #3: The Payroll/Property Test Is Narrow and Subject to Manipulation

A third criticism that has been raised on occasion focuses on the mechanical definitions underlying the 80/20 company calculation. Because states often measure an entity's domestic or foreign operations using property (typically limited to real and tangible property) and payroll (frequently limited to Form W-2 compensation), critics argue that these narrow metrics create an opportunity for manipulation.

But this criticism is nothing more than a broad attack of a method that examines the actual operations of a business rather than its place of legal incorporation. State tax regimes are predicated on consistency and predictability. The factors that define the 80/20 company parameters are among the ones that the U.S. Supreme Court has endorsed as proxies for evaluating business activities.¹⁰ They are the backbone of state apportionment.

Moreover, approaches to the 80/20 concept are neither limited nor uniform. Property and payroll are tried and true metrics for measuring activity — but some states place some, or all, reliance on sales or “active foreign business income.” This variation in and of itself refutes the notion that the 80/20 company test is universally susceptible to manipulation. The diversity of approaches makes clear that states retain the flexibility to calibrate their 80/20 company tests accordingly, allowing for the ability to address vulnerabilities that may arise while preserving the benefits that 80/20 company rules provide.

Conclusion

The 80/20 company rules are neither a loophole nor an antiquity, and getting caught up in the misconceptions surrounding them can cause one to lose sight of their benefits. They are critical to water's-edge regimes and an essential structural component of the framework that has governed state taxation of multinational enterprises for years — a framework that balances the states' legitimate interest in taxing income

connected to their jurisdiction against the constitutional constraints on state taxing power. For the vast majority of multinational taxpayers, an 80/20 regime operates exactly as intended: as a principled, substance-based answer to the question of which entities belong in a state's water's-edge combined filing group. ■

¹⁰ See, e.g., *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16 (2008).