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February 15, 2023

Senator Nicole Grohoski, Co-Chair
Representative Joseph C. Perry, Co-Chair
Joint Standing Committee on Taxation
100 State House Station
Augusta, ME 04333-0100

Dear Committee Co-Chairs:

Pursuant to Resolve 2021, c. 170, I have enclosed the report regarding elective Worldwide Combined Reporting of Certain Corporations for Income Tax Purposes.

Please feel free to contact me if you have any questions about this report.

Sincerely,

Jerome D. Gerard

Jerome D. Gerard

Enc.
cc: Members of the Joint Standing Committee on Taxation
Kirsten LC Figueroa, DAFS Commissioner

# Worldwide Combined Reporting of Certain Corporations for Income Tax Purposes

**Report Prepared for the**
**Joint Standing Committee on Taxation**

**February 10, 2023**

**Department of Administrative and Financial Services**
**Maine Revenue Services**
**Office of Tax Policy**

## Introduction

"Resolve, Directing Maine Revenue Services To Review and Report Regarding Worldwide Combined Reporting of Certain Corporations for Income Tax Purposes" ("the Resolve"), R. 2021, c. 170, directed the Department of Administrative and Financial Services, Maine Revenue Services ("MRS") to review the impact on the State's income tax and the State's economy of adopting a system for apportionment of income for purposes of calculating income tax for corporations that are part of an affiliated group with members outside of the United States.

When performing the review, the Resolve specifically directs MRS to:

A. Review the State's corporate income tax law and identify statutory and administrative changes that would be necessary to adopt a corporate income tax system that requires worldwide combined reporting for income tax purposes and that allows a corporation to elect to compute income on a water's edge combined report;
B. Consider:
   (1) The need to define income of a combined group under worldwide combined reporting;
   (2) The need to adjust the State's income tax nexus laws;
   (3) The need to adjust the State's method of apportioning corporate income for income tax purposes;
   (4) The implications of permitting corporations to elect to file a return based on water's edge combined reporting and conditions under which a corporation may be allowed to withdraw from that election; and
   (5) Any other statutory changes necessary to implement changes to the system described in paragraph A; and
C. Report to the joint standing committee of the Legislature having jurisdiction over taxation matters by February 1, 2023 the projected impact and policy considerations of adopting a corporate income tax system that requires worldwide combined reporting for income tax purposes and that allows a corporation to elect to compute income by a water's edge combined report. Maine Revenue Services shall include in its report an analysis of how such a system would affect conformity of the State's income tax system with the federal income tax system, including changes to the federal system currently being considered by the United States Congress.

## Background

Maine imposes an income tax on all entities organized as corporations that have nexus with the State and Maine net income. The corporate income tax is graduated, with rates ranging from 3.5% to 8.93%. The tax generally does not apply to S corporations, financial institutions that are subject to Maine's franchise tax, or to insurance companies subject to premiums tax.

Maine is both a "water's edge" and "combined reporting" state. "Water's edge" means Maine's corporate income tax looks to income and attributes related to business activity within the geographic boundaries of the United States, discussed further below. "Combined reporting" means a taxable corporation that is a member of an affiliated group and that is engaged in a unitary business with one or more other members of that affiliated group must file a combined report. **Simply put, combined reporting requires a company to add together income and deductions and tax attributes of all its group members (e.g., affiliates), regardless of their location, into one report from which the taxable corporation's taxable share is calculated.**[1] Combined reporting reflects the economic reality that a group of corporations engaged in a unitary business is centrally controlled and managed, acting as a single economic unit generating income together, regardless of the group's corporate structure. By combining the income of the group, both misalignment of income and corresponding tax liability, as well as opportunities to reduce state income taxes by shifting income between controlled corporations through intra-group transactions, is significantly reduced.

Maine utilizes a "water's edge" methodology for determining the income base subject to apportionment (see the Apportionment sidebar),[2] meaning the income subject to apportionment is the income required to be reported on the taxpayer's federal income tax return as modified by Maine law. Therefore, all unitary members of the affiliated group, except those members not required to file a federal return, must be listed on the combined report. Furthermore, the income of a corporation not required to file a federal return may not be included on the combined report.

## Apportionment

The Maine Corporate Income Tax is at its simplest when taxing a corporation that operates solely within the State. However, due to the nature of the modern economy, this is the exception. Most corporations operate both within and without the State, and often outside the United States.

The taxation of interstate corporations raises important limitations under the U.S. Constitution. Maine can only tax a portion of a corporation's income that is associated with the State. This portion is determined by looking at the corporation's total income and then apportioning it to the State based on where the corporation's sales occur.

Although the term "water's edge" is helpful in generally describing the scope of the tax base, the income reported on a taxpayer's federal tax return (and thus included in federal taxable income used as the starting point for determining Maine corporate income tax) can include income with international components. Some important examples of such income are dividends received from foreign corporations, Subpart F income,[3] and Global Intangible Low-Taxed Income ("GILTI").[4]

The purpose of GILTI is to tax global "intangible income" – income which might be easily shifted outside the U.S. to low tax jurisdictions – but which nonetheless remains in important ways conceptually connected to business activity within U.S. boundaries. **The mechanical application of the GILTI regime**

[1] The other common approach to multistate corporate income tax reporting is separate accounting, used by a decreasing number of states, which requires companies to report the income of each of its subsidiaries independently.

[2] In addition to apportionment using the sales factor, payroll and property factors are also commonly used, though there has been a multistate shift in use of those factors towards the sales factor.

[3] Subpart F income under the United States Internal Revenue Code of 1986 and amendments to that Code ("Code") is certain passive or easily mobile income.

[4] For a description of the historical federal and Maine international tax landscape and a more in-depth discussion of GILTI, please see the Study of the Foreign Derived Intangible Income Deduction Addition Modification, Report Prepared for the Joint Standing Committee on Taxation, by the Department of Administrative and Financial Services, Maine Revenue Services, Office of Tax Policy (January 14, 2022, 130th Legislative Session).

**is somewhat complex but can be simply described as creating a federal minimum tax on global intangible income of 10.5% to 13.125%.** This minimum rate is accomplished, in part, through the application of foreign tax credits and a federal rate-setting deduction.

The inclusion in the tax base of income from international companies raises particular apportionment concerns. Maine has a longstanding statutory requirement of allowing a 50% subtraction modification for certain international dividends[5] and similar income, including Subpart F income and GILTI.[6] These 50% subtraction modifications are one of the means available under Maine law to address the constitutional concerns and related apportionment concerns that exist in state taxation of income derived from international transactions.

Despite these subtraction modifications, the Maine Supreme Judicial Court, sitting as the Law Court, in *Tambrands, Inc. v. State Tax Assessor*, held that Maine cannot include in Tambrands' apportionable tax base income from its affiliates operating abroad (e.g., dividends) and apportion such income by factors reflecting only Tambrands' domestic operations (water's edge apportionment factors) and required MRS to include additional factors in the apportionment formula to fairly represent Tambrands' business activity in the State.[7]

In response to *Tambrands*, MRS developed the "Augusta Formula," which, in certain circumstances, includes the apportionment factors of foreign affiliates through worldwide combined reporting. The Augusta Formula bounds a taxpayer's Maine income tax with a lower bound of tax calculated using a water's edge method with no international components (e.g., without dividends, subpart F, and GILTI) and an upper bound of tax calculated using a worldwide combined reporting method.[8] The Law Court later approved the Augusta Formula in *E. I. Du Pont de Nemours & Co. v. State Tax Assessor*, reasoning that the "Augusta Formula's use of the worldwide combined reporting method as a check on the tax assessed on the income of a multijurisdictional corporation with foreign subsidiaries was an appropriate response to our mandate in *Tambrands*."[9]

States faced with the constitutional issues raised by water's edge reporting and the inclusion of income items with international components have adopted differing approaches to address the issue. Some states have enacted elective worldwide combined reporting, the reporting method being reviewed in this report.[10] This apportionment method addresses the potential constitutional deficiencies with strict water's edge reporting by allowing taxpayers to elect worldwide combined reporting.[11] If a taxpayer

[5] While international dividends are now largely exempt at the federal and State level, this 50% subtraction modification remains for those dividends still subject to federal and State tax.
[6] 36 M.R.S. § 5200-A, sub-§ 2, ¶¶ G, CC, and EE.
[7] Tambrands, Inc. v. State Tax Assessor, 595 A.2d 1039, 1045 (Me. 1991).
[8] Maine Tax Alert, Volume 9, No. 4.
[9] E. I. Du Pont de Nemours & Co. v. State Tax Assessor, 675 A.2d 82, 91 (Me. 1996).
[10] California, Connecticut, Washington D.C., Idaho, Massachusetts, North Dakota, Utah, and West Virginia allow elective worldwide combined reporting.
[11] The U.S. Supreme Court has held that worldwide combined reporting is constitutionally permissible. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 US 159 (1983), *Barclays Bank PLC v. Franchise Tax Bd.*, 512 US 298 (1994).

chooses to use the water's edge method instead of worldwide, they may not later complain that it is unconstitutional.

There are many similarities between the Augusta Formula and elective worldwide combined reporting. Both methods include statutory water's edge reporting with international income items, and both utilize worldwide combined reporting to assure the constitutionality of the overall application of the state income tax laws. In fact, both methods arrive at the same result in most instances.

The Augusta Formula and elective worldwide combined reporting reach the same result when worldwide combined reporting results in a higher tax amount than the statutory water's edge method because taxpayers under the Augusta Formula method are required to use statutory water's edge reporting and taxpayers under elective regimes will elect to do so.[12] Likewise, the two methods reach the same result when worldwide combined reporting results in a lower tax amount than the statutory water's edge method because taxpayers under the Augusta Formula method and taxpayers under elective regimes will both choose worldwide combined reporting – with one important exception.

The Augusta Formula and elective worldwide combined reporting reach differing results when worldwide combined reporting results in a lower tax amount than water's edge reporting with all international income tax items excluded because taxpayers under the Augusta Formula method must utilize the water's edge method with all international income tax items excluded, **whereas taxpayers under elective regimes will elect worldwide combined reporting – resulting in a greater tax reduction**.

# Review

MRS reviewed the State's corporate income tax law and identified the statutory and administrative changes that would be necessary to adopt a corporate income tax system that requires worldwide combined reporting for income tax purposes and that allows a corporation to elect to compute income on a water's edge combined report.

In preparing this report, MRS considered the need to define income of a combined group under worldwide combined reporting; adjust the State's income tax nexus laws; adjust the State's method of apportioning corporate income for income tax purposes; the implications of permitting corporations to elect to file a return based on water's edge combined reporting and conditions under which a corporation may be allowed to withdraw from that election; and other statutory changes necessary to implement changes to the system.

[12] States utilizing elective worldwide combined reporting generally make the election binding for a number of years to prevent taxpayers from choosing the option that results in the lower amount of tax every year. Despite this restriction, taxpayers can be expected to choose the reporting method that will generally result in the lowest amount of tax for their circumstances.

## Report of Projected Impact, Policy Considerations and Analysis of Adoption of Elective Worldwide Combined Reporting

The Resolve requires MRS to report to the joint standing committee on taxation by February 1, 2023, the projected impact and policy considerations of adopting a corporate income tax system that requires worldwide combined reporting for income tax purposes and that allows a corporation to elect to compute income by a water's edge combined report and include in the report an analysis of how such a system would affect conformity of the State's income tax system with the federal income tax system, including changes to the federal system currently being considered by the United States Congress.

Elective worldwide combined reporting and the Augusta formula are alternative ways to ensure the constitutionality of the State's water's edge reporting method. As discussed above, both methods utilize worldwide combined reporting and result in similar outcomes in many situations.

**If the State were to switch to elective worldwide combined reporting, taxpayers' ability to use worldwide combined reporting to reduce their tax below what is allowed under current law would be expected to increase the number of worldwide combined reporting returns filed with the State and to reduce State revenue.**[13] Due to the complexities of preparing and reviewing worldwide combined reporting returns, this switch would increase the compliance burdens on taxpayers and the administrative burdens on the State.

Maine's conformity to federal income tax law provides numerous advantages to the State and taxpayers.[14] While federal law would still be available to make income determinations, many of the benefits of conformity would not be available when applying federal income tax law to foreign entities

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[13] MRS does not have direct tax data that would allow the Bureau to estimate the revenue loss that would result from elective worldwide combined reporting.

[14] "When states link to the federal code, it benefits both their residents and their government's tax administrators. Using federal rules and definitions simplifies state returns for taxpayers, who only need one set of documents and calculations for both their federal and state returns. Different states using the same federal laws also helps residents who earn income in multiple states. On the administrative side, states that use the federal code can rely on the IRS, Treasury Department, and federal courts for regulation, guidance, liability determinations, and compliance." Richard Auxier and Frank Sammartino, *The Tax Debate Moves to the States: The Tax Cuts and Jobs Act Creates Many Questions for States that Link to Federal Income Tax Rules*, available at https://www.taxpolicycenter.org/publications/tax-debate-moves-states-tax-cuts-and-jobs-act-creates-many-questions-states-link/full.

"[Conforming to the IRC] allows state administrators and taxpayers alike to rely on federal statutes, rulings, and interpretations, which are generally more detailed and extensive than what any individual state could produce. It provides consistency of definitions for those filing in multiple states and reduces duplication of effort in filing federal and state taxes. It permits substantial reliance on federal audits and enforcement, along with federal taxpayer data. It helps to curtail tax arbitrage and reduce double taxation. For the filer, it can make things easier by allowing the filer to copy lines directly from their federal tax forms. In the words of one scholar, federal conformity represents a case of 'delegating up,' allowing states to conserve legislative, administrative, and judicial resources while reducing taxpayer compliance burdens." Jared Walczak, *Toward a State of Conformity: State Tax Codes a Year After Federal Tax Reform* (Jan. 2019), available at https://files.taxfoundation.org/20190201130844/Toward-a-State-of-Conformity-State-Tax-Codes-a-Year-After-Federal-Tax-Reform-FF-631.pdf. *See also* DELEGATING UP: STATE CONFORMITY WITH THE FEDERAL TAX BASE, 62 Duke L.J. 1267.

because federal income tax law is not being applied in the foreign context to the same extent, or for the same purposes, by the Federal Government. Taxpayers utilizing, or considering, worldwide combined reporting would be required to calculate the income of their foreign entities anew, and MRS would not be able to rely on the IRS to provide written guidance applicable to foreign tax situations, answer taxpayer questions, or take enforcement action. In addition, the State could not rely on Congress to address statutory issues or on federal courts to resolve questions of federal law in this new context. Instead, these functions would need to be performed by the State, creating new burdens on taxpayers, MRS, the State tax appeal process – including the Attorney General's Office, the Board of Tax Appeals, and State courts – as well as on the Legislature.

Water's edge combined reporting with a worldwide combined reporting election is generally regarded as meeting the requirements of the United States Constitution and would be expected to be upheld in Maine if enacted. However, it would be a deviation from the Law Court approved Augusta Formula and, as such, could potentially create some amount of constitutional uncertainty.

In conclusion, this report identifies three policy issues for the Legislature's consideration. First, the increased complexity resulting from an increased number of returns utilizing worldwide combined reporting. This additional complexity would create burdens on taxpayers, MRS, and other agencies and branches of State Government – resulting in increased administrative costs and less effective enforcement of the State's tax laws. Second, the potential constitutional uncertainty raised by deviating from the Law Court approved Augusta Formula. And third, the decreased revenue resulting from a worldwide combined reporting election.