Some More Context for Considering the Water's Edge

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Basics of Tax Policy

The goals of tax policy are often summarized as:

– 1) **Fairness**:
  - Similarly situated taxpayers should pay the same.
  - Those with more ability to pay should pay more.

– 2) **Efficiency**

– 3) **Administrability**

– 4) **Sufficiency**: A tax system that taxed all billionaires $1 would satisfy the first three criteria… but the government could not do its job.

Spot the gaps

FIGURE 1

Fifteen Most Likely Tax Havens in 2020 for U.S. Corporations

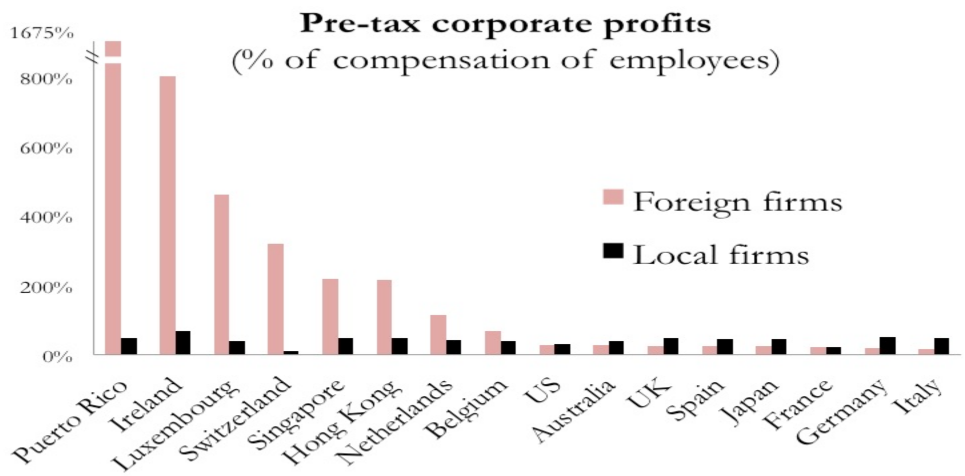
Country	Reported Profits of US Companies (billions)	National GDP (billions)	Profits as % of GDP	Foreign Tax Rate	Profits Per Employee
Bermuda	$39.82	$6.89	578.1%	1.5%	$49,157,126
Cayman Islands	$31.71	$5.65	561.5%	1.7%	$6,874,830
British Virgin Islands	$7.57	$1.49	507.2%	0.7%	$69,428,156
Barbados	$7.59	$4.67	162.4%	1.4%	$4,959,938
The Bahamas	$5.89	$9.75	60.4%	0.0%	$2,921,314
Mauritius	$6.48	$11.40	56.8%	4.2%	$2,195,296
Puerto Rico	$34.29	$103.13	33.3%	1.3%	$418,478
Switzerland	$131.40	$739.91	17.8%	3.9%	$1,428,961
Singapore	$58.41	$348.39	16.8%	5.4%	$339,943
Curacao	$0.27	$2.50	10.9%	0.8%	$1,539,755
Ireland	$45.60	$425.85	10.7%	23.9%	$264,240
Hong Kong SAR, China	$19.21	$344.94	5.6%	13.0%	$214,853
Cyprus	$1.16	$25.01	4.7%	3.7%	$446,806
St. Kitts and Nevis	$0.04	$0.88	4.3%	6.2%	$61,808
Isle of Man	$0.26	$6.68	3.9%	2.4%	$464,566
Total for Most Likely Tax Havens	**$390**	**$2,037**	**19%**	**6%**	**$624,814**
Total for Other Countries	**$270**	**$58,533**	**0%**	**33%**	**$20,413**

Note: Jurisdictions where U.S. corporations reported an overall net loss are not included. These calculations also exclude any jurisdiction that the IRS did not report separately.

Source: Profit and tax data from IRS SOI Country by Country Report for 2020; 2020 GDP

https://itep.org/offshore-tax-havens-corporate-tax-avoidance-demonstrates-need-for-global-minimum-tax/

How about?



Source: http://gabriel-zucman.eu/missingprofits/

But how does profit get to where it was clearly not earned?

For example, imagine Widget, Inc. sells 1 million widgets in CA with a profit margin of $100 each. Instead of paying CA taxes on $100 million in profits, the corporation instead incorporates a subsidiary in a lower-tax jurisdiction and places their intellectual property in that jurisdiction. The foreign subsidiary then charges the US-based company $90 per widget for use of its IP. The US-based Widget corporation now records just $10 million of profits in CA.

And yes, there is granular evidence of such maneuvers, see:

As Senator Wyden and his team have highlighted, AbbVie systematically transfers nearly all the profits on its patent protected medicines out of the United States. In fact, AbbVie reported a $4.6 billion loss in the United States in 2022 – and a near $20 billion offshore profit. The reported U.S. loss is not an aberration – AbbVie has reported a U.S. loss every year between 2013 and 2022. These domestic losses occur even though AbbVie reports that it generates 75 percent of its revenue in the United States, and its blockbuster drug Humira sells at a substantially higher price in the United States than in Europe.[9]

Source: https://www.finance.senate.gov/imo/media/doc/Setser%20Senate%20Finance%20Testimony.pdf

How much is there?

"[P]rofit shifting is still significant, with companies estimated to be shifting more than $300 billion each year in profits out of the United States, and the share of foreign earnings reported in tax havens little changed."

- Edelberg et al. 2022. Six Economic Facts on International Corporate Taxation. Hamilton Project/The Tax Law Center. (Fact #2: "US multinationals still shift profits into lower-tax countries.").

- This is roughly 20% of the federal corporate tax base.
- A 20% increase in California's corporate income tax would therefore yield $4bn because Ca's CIT collections are about $20bn/yr.
  - *The DoF estimates that eliminating the Water's Edge election would raise about $4bn/yr, which thus seems quite reasonable to me, subject to significant caveats.* [*https://dof.ca.gov/media/docs/forecasting/revenue-and-taxation/tax-expenditure-reports/2025-26-Tax-Expenditure-Report.pdf*](https://dof.ca.gov/media/docs/forecasting/revenue-and-taxation/tax-expenditure-reports/2025-26-Tax-Expenditure-Report.pdf)

Simply Put

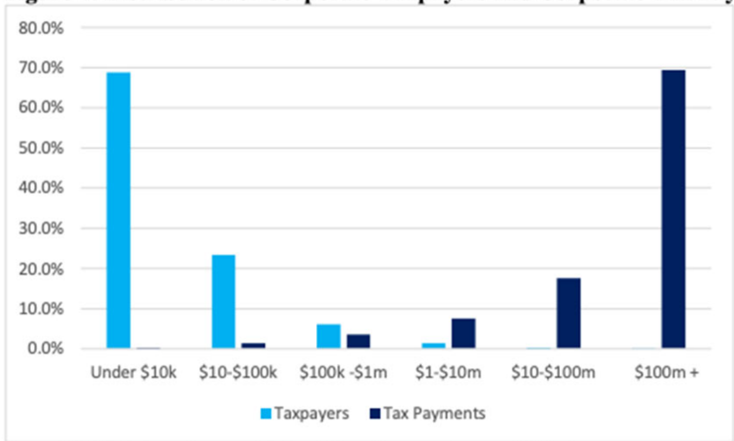
- "While the magnitude of corporate profit shifting by U.S. multinationals into low or no tax countries is uncertain, there is overwhelming evidence of its existence and its increase in recent years."
  - Jane G. Gravelle, Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?, April 2016, http://www.law.nyu.edu/sites/default/files/upload_documents/Jane%20Gravelle.pdf

Not getting better

- "Tax havens are as available today as they were prior to the 2017 tax reform."
  - U.S. Department of the Treasury, "The Made in America Tax Plan" at 9 (Apr. 2021).

There are differences in corporations, with only a handful paying most of the tax.

Figure 4: Distribution of Corporate Taxpayers and Corporate Tax Payments, 2019



Source: IRS Statistics on Income data for 2019 on C corporations; see Table 4.

- Source: Clausing, Kimberly A., Capital Taxation and Market Power (May 21, 2024). Available at SSRN: https://ssrn.com/abstract=4419599

And not all MNCs have equal appetite and/or means

- For example,
- "Our elasticity estimates show that the most tax-aggressive MNEs respond up to 18 times more than do the least aggressive firms."

- Bilicka et al., *Tax Policy, Investment and Profit-Shifting*, https://www.law.columbia.edu/sites/default/files/2023-03/BDG_2023_03_23.pdf

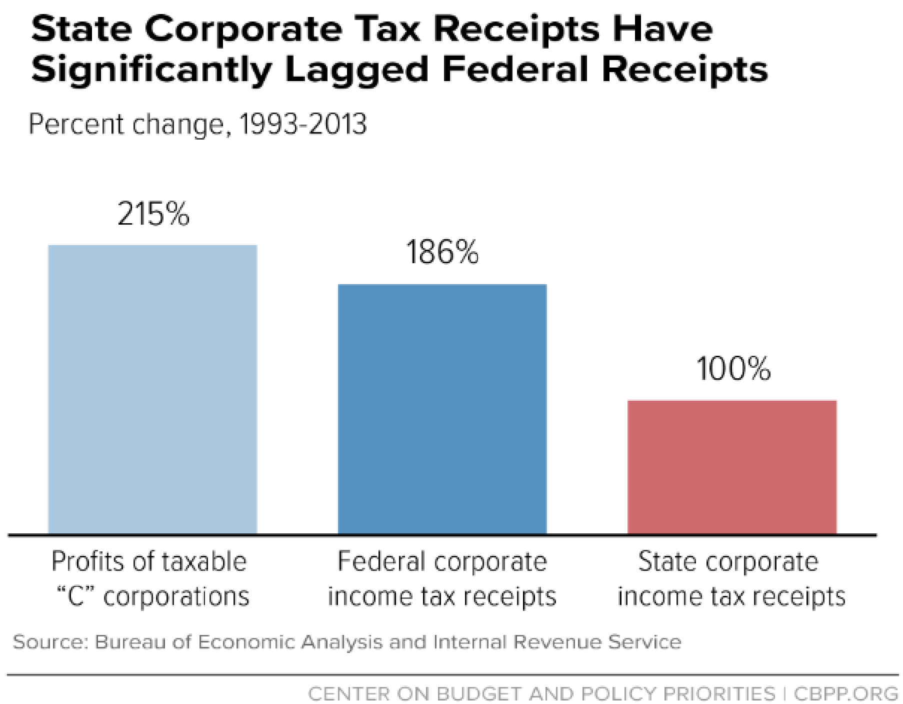
Note on who pays the CIT (Economic incidence)

- Figuring out the economic incidence of the CIT is fraught.
- The general estimate of the Joint Committee on Taxation is that capital bears most of the tax, especially at first, but then:
  - "In estimating the long-run burden of corporate income taxes on capital and labor, the Joint Committee staff follows the middle range of the current economic literature by assuming that 25 percent of corporate income taxes are borne by domestic labor and 75 percent are borne by owners of domestic capital."
- The JCT estimate might be too low, as the nature of corporate profits change. Here is the Tax Policy Center:
  - "A significant portion of the corporate tax (TPC estimates about 60 percent), however, falls on excess returns or economic rents. TPC assumes 100 percent of the tax on economic rents falls on corporate shareholders, although some recent research suggests some of tax on rent may be borne by other corporate stakeholders, primarily top management." https://www.taxpolicycenter.org/briefing-book/who-bears-burden-corporate-income-tax

Thus the design of the Ca CIT fails…

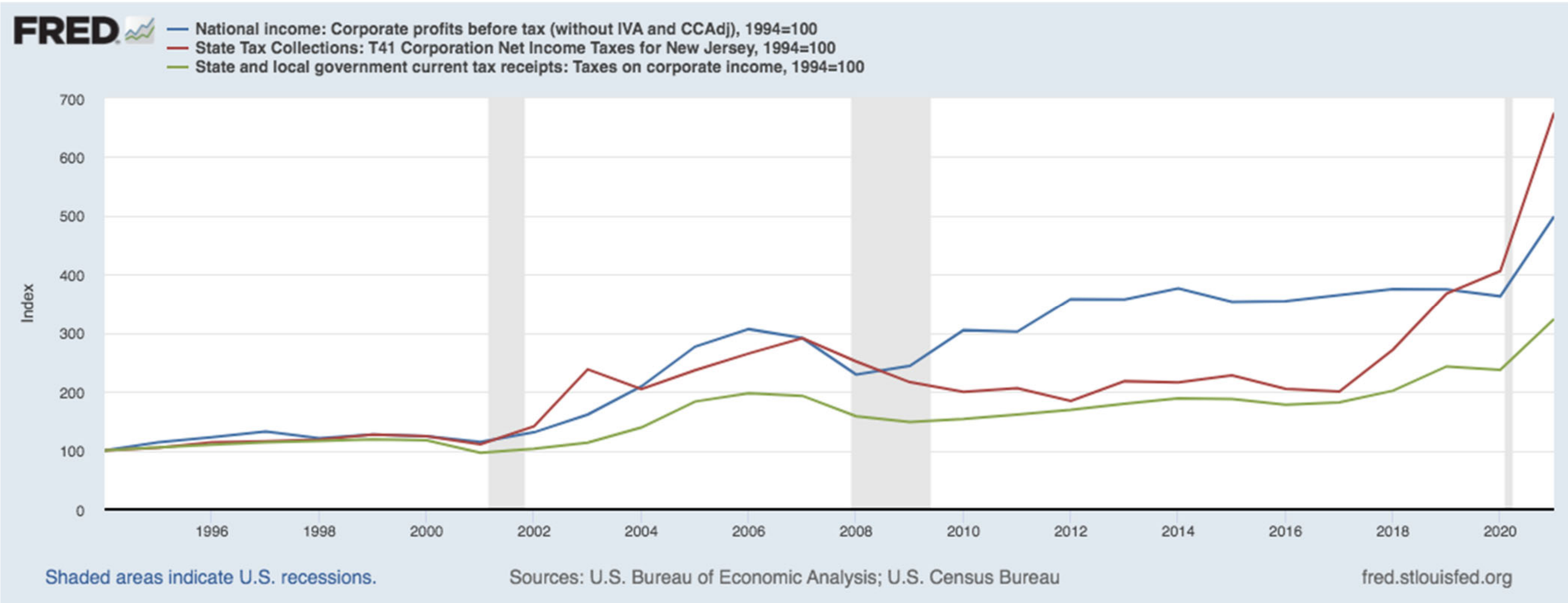
- Every criteria for sound tax policy:
  - It is unfair: to smaller and domestic businesses, but also less aggressive MNCs.
  - It is inefficient, as it encourages wasteful tax evasion.
  - It is hard to administer because of games.
  - The evasion is a big part of the tax base.
    - If you look at California’s tax expenditures, none is as large as the Water’s Edge election relative to the tax.

Should we just give up?



http://www.ncsl.org/Portals/1/Documents/Taskforces/GILTI.pdf

But NJ !



Caution: NJ adopted several CIT reforms at once (at least one of which CA has already done). The significance of this chart is not to guarantee future results but to show that CIT reform can really matter.

There are several ways forward.

- It is important to reject defeatism. There are multiple solutions available to the state, including:
  - Worldwide combined reporting (WWCR): don’t treat income shifted abroad as outside the tax base.
    - Takes advantage of CAMT and Pillar 2.
  - Conform to NCTI, which brings back in shifted income by formula.
  - Adopt WWCR for large taxpayers, NCTI for smaller.
  - In all events adopt other anti-abuse protections.

Alphabet Soup Speed Round

- Ca pioneered WWCR until it was forced to abandon it in 1987.
- The resulting/current compromise means that Ca taxes some ”foreign” source income but ineffectually and irrationally.
  - California currently bring certain income of foreign subs into the tax base of US taxpayers if 1) it represents an older attempt to combat income stripping (subpart F) or a foreign sub actually mails a check back to its US parent (foreign dividends).

NCTI?

- NCTI income is the income of the foreign subs of US multinationals – 60% of that income is brought back into the US taxbase, subject to complicated (and, flawed in their own right) rules as to whether sufficient tax was paid on this income abroad.
- NCTI was created by the TCJA in 2017 and modified by the OBBBA in 2025. Clever tax planners can transform subpart F income (included in Ca) into NCTI income (not included).

Corporate Alternative Minimum Tax

- New tax put in place by Inflation Reduction Act.
- Only applies to big corporations (over $1bn).
- Applies a 15% tax to adjusted financial statement income (AFSI).
- Consolidation – worldwide.
- Use financial statement income v. taxable income.
- Complicated interaction with OBBBA but even if practically eviscerated (for now) still requires large taxpayers to make calculations based on their financial statements.

Pillar Two?

- Pillar Two, a reform developed at the OECD, aims to make sure that every taxpayer pays at least a minimum amount of tax (15%).
- It applies to large taxpayers and requires substantial use of financial reporting data.

But no one else is doing it!?

“A simple analogy from sports refutes the […] point. Suppose that each team in a basketball league inexplicably tied their players’ shoelaces together. A team could clearly improve its competitiveness by untying its players shoelaces, no matter what other teams did.”

- Charles McLure, preeminent tax economist, discussing a similar argument made as to why states should not improve their sales taxes, https://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/hearings/ProfMcLure_Testimony_revised.pdf

Here is some evidence and facts re compliance

- "The California Court of Appeal additionally found that Barclays' actual compliance costs were 'relatively modest' during the years just prior to those here at issue, ranging from $900 to $1,250 per annum, for BBI."
- Barclays, 512 U.S. 298, 314, n.13 (citing 10 Cal. App. 4th, at 1760, n.9)."

Also

- As the Supreme Court also noted in Barclays, under the California WWCR regulations, taxpayers could use "reasonable approximations" based on ordinary financial records for calculating the income of foreign subsidiaries in connection with WWCR.
- These regulations are still there – and still used! – because taxpayers can and do elect to file on a worldwide basis in California. See Cal. Code Regs. tit. 18, section 25106.5-10(e)(1).

More fundamentally

- It is surreal to suggest that these MNCs will have huge difficulties figuring out estimated income and sales.
  - In many cases, they already need to disclose their sales for purposes of securities law or Pillar 2.
  - In many cases, they already have to calculate their income using financial statements for purposes of the CAMT or Pillar 2.
  - BUT given the fact that there is *some* fixed compliance cost – it would not be unreasonable to limit WWCR to taxpayers already subject to the CAMT or Pillar 2.

Federal securities law?

From Amazon's 2022 Annual Report.

	2020	2021	2022
United States	$ 263,520	$ 314,006	$ 356,113
Germany	29,565	37,326	33,598
United Kingdom	26,483	31,914	30,074
Japan	20,461	23,071	24,396
Rest of world	46,035	63,505	69,802
Consolidated	$ 386,064	$ 469,822	$ 513,983

It just makes sense for Amazon to tell us this, but note that it has to under accounting standards. FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 131, 42 (1997). And these accounting standards must be complied with as part of federal securities law.
https://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf, P.50

Thank you!

- Please follow up with any questions.