Should States Embrace GILTI?

by Jéanne Rauch-Zender

Congress inserted several provisions into the Tax Cuts and Jobs Act, arguably intended to address corporate arrangements when federal taxable income on which the states rely is disconnected from profitability, perhaps most significantly a tax on global intangible low-taxed income. In this installment of Board Briefs, I asked *State Tax Notes* board members to weigh in on whether states should embrace GILTI.

This article is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

A Cost-Benefit Approach

Walter Hellerstein is the Distinguished Research Professor Emeritus and the Francis Shackelford Professor of Taxation Emeritus at the University of Georgia Law School and chair of the *State Tax Notes* Advisory Board.

In the venerable tradition of answering a question by asking a question, I would answer the question, "Should states embrace global intangible low-taxed income?" by asking: "Are the costs worth the benefits?" To avoid unreasonable expectations regarding the scope and objective of my proposed cost-benefit inquiry, I begin with some caveats. First, the inquiry does not consider the merits of taxing GILTI as a matter of national tax policy, but simply takes the federal corporate income tax base as a given to which states generally conform. Second, the inquiry assumes that raising revenue is a benefit. Although one may take issue with that assumption because every dollar of "benefit" is a dollar of "cost" to taxpayers, the inquiry proceeds from the premise that the "civilized society" for which "taxes . . . pay" is a net benefit.[1] Third, the inquiry does not yield an unequivocal answer that will command universal support. Instead, my more modest objective is simply to provide a framework within which the inquiry might proceed with the hope that it will advance meaningful discussion and enhance the probability of resolving the question of whether states should embrace GILTI in a sensible manner.

The benefits of embracing GILTI are fairly obvious. First, it brings with it the benefits of conformity: namely, easing compliance and auditing burdens, which has been the prime force responsible for the very wide conformity of the state corporate income tax base to federal corporate income tax base.[2] Second, as I have already suggested, or, more precisely, assumed, embracing GILTI provides a benefit by enhancing state revenues and helping to "pay for civilized society." It is difficult to overstate the value of that benefit.

What are the costs of embracing GILTI that need to be weighed against these benefits? Although a detailed answer to this question cannot be provided within the confines of a Board Briefs contribution,[3] the ensuing discussion seeks to identify the principal costs associated with states' embrace of GILTI. First, the presumed benefits of conformity may well be outweighed by the costs of conformity, at least from an administrative perspective. In other words, there is less than meets the eye to the benefits of

[1] *CompañiaGeneral de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) ("Taxes are what we pay for civilized society.").

[2] *See* Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para. 7.02 (3d ed. 2018 Rev.).

[3] For a more expanded analysis of this question, see Walter Hellerstein and Jon Sedon, "State Corporate Income Tax Consequences of Federal Tax Reform," *State Tax Notes*, Apr. 16, 2018, p. 187; and Hellerstein, *State Taxation*, *supra* note 2, para 7.16A[2]. The following discussion draws freely from these sources.

conformity when one is talking about GILTI. New IRC section 951A, which effectively defines GILTI, appears in subpart F, and in substance treats GILTI as a deemed dividend received from a controlled foreign corporation under subpart F. Nevertheless, GILTI is not technically subpart F income as defined by the IRC. Indeed, the definition of GILTI — the U.S. shareholder's "net CFC tested income for such taxable year" over the shareholder's "net deemed tangible income return for such taxable year"[4] — explicitly excludes from the net CFC tested income, "any gross income taken into account in determining the subpart F income of such corporation."[5] Yet for purposes of other IRC provisions, GILTI is "treated in the same manner as an amount included" under subpart F.[6]

What may appear superficially to be fine semantic distinctions regarding the characterization of GILTI for federal income tax purposes has significant implications for purposes of the states' treatment of GILTI under their conformity provisions. Most states do not conform to subpart F.[7] However, as noted above, the IRC explicitly excludes GILTI from the definition of subpart F income, although section 951A (the provision subjecting GILTI to tax) falls squarely within subpart F. How states will construe these technical distinctions between subpart F income and income subject to tax under subpart F raises technical questions of extraordinary complexity (especially to state tax administrators not schooled in the details of subpart F and the Tax Cuts and Jobs Act), and significantly undercuts the argument that state conformity to the IRC constitutes an administrative benefit rather than an administrative cost.

Similar questions can and no doubt will be raised about the 50 percent deduction for U.S. shareholders that are subject to tax on GILTI. Will states that conform to the inclusionary provision likewise conform to the federal deduction, which falls within the part of the IRC listing "Special Deductions for Corporations"? Will the answer to this question depend on whether a state conforms to federal taxable income before net operating loss and special deductions (line 28 of the most recent version of federal Form 1120) or federal taxable income after NOLs and special deductions (line 30 of the most recent version of Form 1120)?

Wholly apart from the costs associated with state statutory issues raised by embracing GILTI, there is a host of thorny constitutional issues raised by the inclusion of GILTI in the states' corporate tax base. For example, if a state determines as a matter of statutory construction that it conforms to the GILTI inclusion, but not to the GILTI deduction, would that frustrate federal policy in violation of the supremacy clause? Even if including GILTI in the tax base raises no supremacy clause issues, does GILTI constitute constitutionally apportionable income in the U.S. shareholder's apportionable tax base under the commerce and due process clauses? Assuming the U.S. shareholder is not domiciled in the taxing state, the answer to this question will depend on whether the U.S. shareholder is engaged in a unitary business with its CFC or whether the CFC is serving an "operational function" in the U.S. shareholder's business. Assuming that GILTI is constitutionally includable in the U.S. shareholder's apportionable tax base, questions may then arise regarding the fairness of the apportionment of that income from a constitutional standpoint, including whether the CFC's factors should be included in the U.S. shareholder's apportionment formula and, if so, on what basis. Furthermore, in addition to questions of apportionability and fair apportionment, there is the question of whether the state's taxation of GILTI discriminates against foreign commerce by taxing income of CFCs that would not be taxed if earned by equivalent controlled *domestic* corporations. As anyone who is still reading this Board Brief is well aware, answering the foregoing questions can involve long, complex, and expensive inquiries with uncertain outcomes.

As noted at the outset of this brief, my proposed cost-benefit analysis promised no definitive answer to the question whether states should embrace GILTI. My principal objective was to suggest the apparent benefits of conformity and increased revenue that may well be offset by the costs of conformity, and controversies over the inclusion that could well lead to the conclusion that inclusion of GILTI is not worth the candle.

---

[4] Section 951A(b).

[5] Section 951A(c)(2)(A)(i)(II).

[6] Section 951A(f).

[7] See sources cited *supra* note 3 indicating that only about one quarter of the states with corporate income taxes include federal subpart F income in their provisions conforming to the federal tax base.

If It's Not Broken, Don't Fix It

Eric J. Coffill is a senior counsel with Pillsbury Winthrop Shaw Pittman LLP, Sacramento, California.

Much can be said about GILTI and its impact on the states, but let me just focus here on GILTI and California. Apart from some rolling conformity regarding the water's-edge election provisions,[8] California conforms to the version of the IRC in place as of a static date, which is January 1, 2015.[9] Accordingly, there is no current California conformity to GILTI, nor will there be any, without a law change by the Legislature. To the surprise of many, there was no California-to-TCJA conformity legislation in 2018, even though the TCJA was signed December 22, 2017. However, a conformity bill of some sort is anticipated in 2019 under our new governor, Gavin Newsom (D). What kind of conformity, if any, might there be regarding GILTI? The answer should be "none."

Commentators seem to agree that the TCJA is a move away from a worldwide system of taxation to a quasi-territorial system, which includes GILTI. For states that previously did not include foreign income in their tax bases, the policy question behind adopting or not adopting GILTI is relatively straightforward; that is, whether to use GILTI to expand the state's domestic corporate tax base to now include foreign income. It is far from a straightforward question in California, however, because the state already includes foreign income in its corporate tax base under two approaches. First, California continues to use the worldwide unitary method of taxation, which was constitutionally blessed for both domestic and foreign parent corporations in *Container*[10] and *Barclays Bank*.[11] If foreign entities are in the worldwide combined report, their income (and factors) are included in the California tax base computations. Because that base includes all the (business) income of the foreign members of the worldwide combined report, a move to include only GILTI logically would decrease the California tax base. Thus, unless the Legislature wishes to shrink its tax base, which is highly unlikely, GILTI conformity makes no sense as a substitute for California's worldwide combined reporting method.

That leads us to the second approach. Beginning in 1988, California has offered taxpayers a statutory water's-edge election, under which a taxpayer chooses to use less than a worldwide tax base, but which includes specific foreign income.[12] The election mechanism involves what is referred to as the "inclusion ratio," under which the water's-edge tax base includes a CFC's net income as multiplied by a fraction, the numerator of which is the subpart F income of the CFC and the denominator of which is the earnings and profits of the CFC for that tax year.[13] Thus, and unlike the vast majority of states, California already has a mechanism in place for including and taxing a portion of foreign income, and has had the mechanism successfully in place for more than 30 years. How could California conform to GILTI in light of the water's-edge provisions already in place? It would involve a policy decision by the Legislature to abandon the inclusion ratio method and replace it with a new GILTI provision.

A taxpayer makes the water's-edge election with the Franchise Tax Board for an initial 84-month period, and the election remains in place thereafter until terminated.[14] Overlooking the obvious fact that such a legislative change could not apply to the thousands of water's-edge elections already in place, under what reasoning would such a change make sense? The subpart F provisions in the current election have worked well for more than 30 years. Other than a bit of litigation many years ago over the mechanics of

---

[8] Cal. Rev. & Tax. Code section 25116.

[9] Cal. Rev. & Tax. Code sections 23051.5 and 17024.5.

[10] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

[11] *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

[12] 1986 Cal. Stat. ch. 660. *See* Cal. Rev. & Tax. Code section 25110 et seq.

[13] Cal. Rev. & Tax. Code section 25110.

[14] Cal. Rev. & Tax. Code section 25113.

the dividend ordering provisions,[15] there has been no litigation involving or challenging them. They have survived many legislative changes to other provisions of the water's-edge election, including those in 1993 and 2003, which changed the terms of the election, abandoned the election fee, removed the so-called "death penalty," and abandoned the domestic disclosure spreadsheet.[16] It is also important to recall that the election has its roots not in the Legislature, but in the thought and work product from the 1984 Final Report of the Worldwide Unitary Taxation Working Group,[17] which was organized by U.S. Treasury Secretary Donald Regan in September 1983 after California's win in the U.S. Supreme Court in *Container*. There is lots of history behind this issue. Had the Legislature wanted to amend the Subpart F provisions in the current election, it has had plenty of opportunities over the years and has chosen to remain silent.

An interesting, and a probably long-forgotten, fact is that the first version of the California water's-edge election legislation, S.B. 85, as introduced in 1985, did not cover the inclusion ratio for the taxation of subpart F income. What it *did* include was a provision that the water's-edge group included "any affiliated bank or corporation with activities in or located in a tax-haven country," which was defined as a country that "either does not impose an income tax or if its statutory income tax rate is less than 65 percent of the maximum U.S. corporate income tax rate."[18] However, before S.B. 85 was signed into law by then-Gov. George Deukmejian on September 5, 1986, the tax haven provision had been removed or replaced. Conference Report (between the Senate and Assembly) amendments to the bill in August 1986, shortly before its passage in the Legislature, added the subpart F provisions now found in the law, which "substitutes [them] for the Senate version's inclusion within the water's-edge of 'tax haven corporations,'"[19] which were then removed from S.B. 85. Thus, the subpart F provisions and the inclusion ratio dating to S.B. 85 were *deliberately chosen* by the Legislature over tax haven provisions. The GI "low tax" intangible provisions are simply another version of tax haven provisions, which were already considered and rejected in California in favor of the subpart F provisions. Clearly the Legislature preferred one over the other.

Abandoning this key provision of the water's-edge election in lieu of GILTI would be far more than a mere "incorporation by reference" federal conformity update to the TCJA — it would be a major, fundamental change to more than three decades of law and tax policy with its roots in the working group and the legislative history of the water's-edge election. If the purpose of GILTI under the TCJA is to adopt a quasi-territorial system by including foreign income, California already has had such a system for decades (under both the worldwide method and the water's-edge election). Is there an argument that GILTI is a better approach? I have not seen the case made for such a claim, unless "better" is read to mean the adoption of a system that will increase California taxable income and thus increase taxes on multinational taxpayers. One commentator[20] has suggested leaving the existing water's-edge inclusion ratio provisions in place, but requiring an alternative GILTI computation, and then requiring taxpayers to include the *higher* income amount in the combined report. Clearly there would be actual multiple taxation if the same income is subject to inclusion in both the inclusion ratio and as GILTI. Admittedly, running alternative computations is a solution to the double-tax issue. But on its face, this approach is nothing more than a wolf (tax increase) in sheep's (tax policy conformity) clothing. If the use of alternative computations is indeed offered for policy reasons and not to increase taxes, then the proper alternative approach would be to include

[15] *Fujitsu IT Holdings Inc. v. Franchise Tax Board*, 120 Cal. App. 4th 459 (2004); *Apple Inc. v. Franchise Tax Board*, 199 Cal. App. 4th (2011).

[16] *See* Eric J. Coffill, "California's New Water's Edge Election Provisions," *State Tax Notes*, Dec. 8, 2003, p. 845; Coffill, "A Kinder, Gentler 'Water's-Edge' Election: California Wards Off Threats of U.K. Retaliation As Part of Comprehensive Business Incentive Tax Package," *State Tax Notes*, Oct. 25, 1993, p. 965.

[17] Final Report of the Worldwide Unitary Taxation Working Group, Chairman's Report and Supplemental Views, Office of the Secretary, Department of Treasury (Aug. 1984).

[18] S.B. 85, as amended in Senate Jan. 24, 1985.

[19] *See* Senate Rules Committee, Office of Senate Floor Analysis, Bill No. S.B. 85, Proposed Conference Report No. 1, Aug. 21, 1986, p. 2.

[20] Darien Shanske, "California and GILTI" (Dec. 27, 2018); *see also* Amy Hamilton, "Debate Over California's Treatment of GILTI Gets More Interesting," *State Tax Notes*, Jan. 7, 2019, p. 71.

the *lower* of the two amounts in the water's-edge combined report.

Finally, one cannot simply gloss over the complexity of the mechanics of how one would approach taxing GILTI at the state level using apportionment (understanding that adoption of GILTI at the federal level does not pose constitutional apportionment problems as it does for the states). California already has a multitude of apportionment formulas with different definitions of factors and different weighting of factors for different fact patterns and industries. The sales factor is especially complicated in California. What of external consistency, which requires that a state can tax "only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed"?[21] New York appears to be planning to include GILTI income (but not the receipts regarding the generation of GILTI) in the apportionment factor denominator (less the 50 percent GILTI deduction allowed at the federal level), but not in the numerator. New Jersey appears to be planning to tax GILTI using a separate special accounting method based on a net GILTI amount. Neither approach is satisfactory because it is not clear how these approaches are related to either the activities (that is, the receipts/factors) that contribute to the generation of GILTI or the taxpayer's business presence in the taxing state. Likewise for Pennsylvania, which has taken the position that because its law specifically excludes dividends from the sales factor, and because Pennsylvania will treat GILTI income as dividend income for corporate net income tax purposes, GILTI income is not in a corporation's sales factor — so no factor representation whatsoever for GILTI income.

The subpart F inclusion ratio for foreign income has worked well in California for more than 30 years as part of the water's-edge election. If it's not broken, don't fix it.

[21] *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989); *see also Container*, 463 U.S. 159, at 169.

Proceed with Caution, Hazards Ahead

Valerie C. Dickerson is a tax partner and leads Deloitte Tax LLP's Washington National Tax-Multistate practice.

While the tax department trend continues of "doing more with less," the sheer increased administrative burden of post-tax-reform state filing compliance leaves many "doing less with more" — less time on analysis and planning, and more time on compliance with increased complexity, if not increased volume. While a number of states (and localities notably, the city of Philadelphia) have prioritized issuing timely guidance, even more is needed. For example, the GILTI computations involve, among other things, expense apportionment, foreign tax credit utilization, and consolidated return principles for purposes of undertaking the complex computations necessary for GILTI. Should states leave taxpayers to choose between allocating federal consolidated computations back to the various state filers versus undertaking state-specific computations? Depending on the facts, the difference in computational methods could have a significant impact on the reported GILTI inclusion.

Conformity isn't just a matter of opting in or opting out. Important state tax policy decisions are at stake. State tax policymakers have the opportunity to reflect on the federal and state taxing regimes and the carefully considered means by which their state has previously dealt with arguably the same issues. For example, both GILTI inclusion and the states' related-party intangible expense addbacks and unitary combined filing provisions arguably deal with the same concept of perceived profit shifting through intangibles. That realization alone should urge caution against potential overlapping policies that possibly over-complicate the matter. What do we want to accomplish with our state taxing regime, and have we accomplished that? At the least, any choice for "opting in" should come with accommodations for the pre-existing state taxing regime.

In any event, whether a state conforms to the GILTI regime, taxpayers need guidance. For example, worldwide combined reporting taxpayers need guidance on the treatment of GILTI inclusion. Logically, if a CFC is already included in a worldwide return, its income should not again be included as GILTI to its shareholder. Since most GILTI inclusions may not be able to be eliminated as an intercompany transaction, states may lack a clear mechanism to exclude it in a combined report. Guidance on similar questions of mechanics will be important in water's-edge combined reporting states as well.

Companies facing inadequate factor representation as compared to the amount of GILTI inclusion may consider computing taxable income and filing on a worldwide basis even in water's-edge combined reporting states to alleviate the increased tax burden. However, states could potentially stem that tide by confirming a dividend-received-deduction (DRD) approach or by adopting additional apportionment factor provisions that deal with GILTI inclusion more specifically.[22] Lack of specific guidance that considers the unique qualities of GILTI inclusion leaves taxpayers to develop their own reasonable approaches. A variety of non-statutory approaches may be reasonable depending on the circumstances, among them (1) including CFC gross receipts in the sales factor denominator, or (2) for three-factor states, likewise including CFC payroll and property factors in the denominator in addition to sales. States seeking to avoid future tax controversy arising from confusion about the rules might ease current burdens and future disputes by providing preemptory affirmative notice on the matter of apportionment.

States adopting or considering adopting the GILTI provisions face the responsibility to ensure that treatment of taxpayers with non-domestic subsidiaries is consistent with that of taxpayers with domestic subsidiaries. For a separate-filing

[22]States are constitutionally required in any apportionment formula to use factors that "actually reflect a reasonable sense of how income is generated." See *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

state that normally would exclude the income of a foreign subsidiary or afford a DRD for a dividend of foreign income, that state might consider extending that foreign income exclusion or DRD to GILTI income. While not strictly a dividend, there is an obvious comparison to a dividend at the highest level since GILTI is a form of, or portion of, net income included in the income of its shareholder. In addition to providing consistency, extending the foreign income exclusion or DRD to GILTI would provide valuable reliance authority and help ease the compliance burden for taxpayers.

Regardless of whether a state conforms to the GILTI regime, the battle for certainty will continue. Absent pertinent state tax guidance, a mix of both practicality and experimentation seem likely to prevail with years of resolution to come.

GILTI Requires Thoughtful Consideration

Lynn A. Gandhi is a partner with Honigman LLP, Detroit.

Many states have focused on the treatment of GILTI as subpart F income and the availability of a foreign dividends received deduction. But that determination is only part of the review required when considering the inclusion of GILTI in the state tax base. A complete review requires consideration of representation in the states' apportionment factors.

State tax administrators and others are well advised to read, and reread, Justice John Paul Stevens's dissent in *Mobil Oil v. Commissioner of Taxes of Vermont*.[23] In *Mobil*, the U.S. Supreme Court addressed the constitutionality of including foreign dividends in a corporation's tax base to ensure the state did not tax value attributable to activities conducted out of state. The Court interpreted the case narrowly and focused on the inclusion of the foreign dividends in the tax base as primarily a question of the unitary nature of the taxpayer's business, and not a question of factor representation. That is because the majority of the Court believed the apportionment argument had been abandoned in the lower court proceedings. The Court held that the foreign dividends could be included in Vermont's tax base because the activities that occurred overseas contributed to the taxpayer's Vermont operations. However, Stevens addressed factor representation in a dissent filed on both procedural and substantive grounds.

Stevens believed there were significant constitutional concerns regarding the apportionment formula when taxing income earned outside of the taxing jurisdiction. He stated "apportionment goes hand in hand with the determination of the tax base" and "[T]he question whether Vermont may include investment income in the apportionable tax base should not be answered in the abstract without consideration of the other factors in the allocation formula." Thus, there must be consideration of how GILTI will be represented in the apportionment factor for a state's response to the inclusion of GILTI to be complete. Simply including GILTI, or a portion thereof, in the state tax base without any factor representation fails to address that constitutional concern.

Stevens summarized it best: "It is improper simply to lump huge quantities of investment income that have no special connection with the taxpayer's operations in the taxing State into the tax base and to apportion it on the basis of factors that are used to allocate operating income."

At the time of his dissent, Vermont imposed an equally weighted three-factor formula, but the same constitutional concerns would be present, and perhaps magnified, under the single-sales-factor formula prevalent in many states today. State statutes, such as those in effect in Massachusetts, may statutorily provide for the exclusion of dividends in the apportionment formula, but the impact in fact when including GILTI in the tax base may require another look at such language. Constitutional concerns cannot simply be legislated away.

[23] 445 U.S. 425 (1980).

The GILTI Rorschach Test

Helen Hecht is general counsel for the Multistate Tax Commission.

In a previous submission on tax reform, I referred to the writings of the French philosopher Albert Camus. In preparing this submission on GILTI, I kept thinking about another famous French philosopher, Jean-Paul Sartre. I can sum up what I remember of Sartre's existential philosophy as follows: Things mean exactly what we decide they mean. Easy to say, perhaps. But even Sartre admitted that he sometimes mistakenly "confused things with their names."

Those opposing state taxation of GILTI don't want us to confuse its name — global intangible low-taxed income — with what they say it is. They claim the excess foreign income may not really be from intangibles. But even if that claim was susceptible to empirical proof, it doesn't change the fact that Congress can, and often does, decide what things are for tax purposes, even if they aren't, for any other purpose.

Whatever we call it (and I personally like the name) we have to decide what GILTI means. Unfortunately, that's a bit of a Rorschach test. It may depend on our subjective viewpoints. All I can do, therefore, is offer mine.

I have to start with two historical events. The first involves the Worldwide Unitary Taxation Working Group, which was convened by the Reagan administration after the U.S. Supreme Court upheld worldwide combined filing in *Container*.[24] The members of the group that opposed worldwide combined filing convinced states to voluntarily abandon that method in favor of conforming to federal sourcing rules. But the states didn't give up without pointing out the weaknesses in those rules and exacting a promise from the administration that the federal government would work to address those weaknesses and provide specific assistance to "promote full disclosure and accountability" of corporate information.[25] Suffice it to say, only the states kept their part of this bargain.

The working group reached no agreement on the taxation of foreign dividends. Instead, that issue was eventually addressed in the *Kraft*[26] case, which held that taxing foreign dividends while giving a deduction for similarly situated domestic dividends was facially discriminatory. I have said publicly that I believe *Kraft* is limited to its facts. I have my reasons, two of which I'll share. First, although *Barclays Bank*,[27] decided two years later, also raised foreign commerce discrimination claims, not one of its opinions cites *Kraft* (not even the dissent). Second, the Court has cited *Kraft* only twice in 25 years, and neither was a tax case. But despite my belief that the Court has no intent to expand *Kraft* beyond its facts, I don't deny that it changed the trajectory of state taxation of so-called foreign-source income.

Of course, GILTI is not foreign dividends or even "deemed dividends." If it were, under the TCJA, it wouldn't be taxable because the TCJA now provides a 100 percent deduction for dividends of CFCs. Nor does GILTI end deferral of U.S. tax, as some have said. GILTI simply makes what would not be taxable (foreign income of a CFC) taxable (as income of the domestic parent). And that brings me to whether states should tax GILTI, and if so, how.

Here's what I think matters. First, Congress enacted GILTI because it recognized what the states asserted in 1984 — that (pre-TCJA) tax rules were insufficient to stem the tide of shifting profits to low-tax jurisdictions. It also recognized that the post-TCJA system (in which foreign-sourced income would never be taxed) made this problem worse.[28] Second, while GILTI is technically not domestic-source income, it is also not treated as foreign-sourced; and although it is entitled to a foreign tax credit, that credit is more limited than the general credit. Third, for tax purposes, at least, GILTI does not represent the profits from operations but, as the name suggests,

[24] *Container*, 463 U.S. 159, 182.

[25] *See* the Final Report of the Worldwide Unitary Taxation Working Group, *supra* note 17.

[26] *Kraft General Foods v. Iowa Department of Revenue*, 505 U.S. 71 (1992).

[27] *Barclays Bank*, 512 U.S. 298.

[28] *See* Report of the Committee on Ways and Means.

from the excess return deemed attributable to intangible value (however that may be described).

States are justified, therefore, in taxing GILTI, even if they give a nod to *Kraft*, and provide some sort of DRD. If, instead, they choose to include the full amount of GILTI in the state tax base and provide factor relief, it would be consistent with the nature of the income to do so by simply by adding GILTI to the receipts factor denominator. Finally, there may be other theoretically acceptable methods, including backing into the post-credit federal tax base and including that amount in base income for state tax purposes, apportioned by domestic factors.

Finally, there are those who claim that taxing GILTI might be too difficult, because states must determine whether foreign CFCs are unitary. But I might argue this mistakes the nature of GILTI, which is deemed income of the domestic parent. (And I assume the parent is unitary with itself.) But even if the unitary relationship with the CFC must be considered, I believe the states are up to that task.

GILTI Is Bad Tax Policy but Good for Business

Janette M. Lohman is a partner with Thompson Coburn LLP in the St. Louis office.

If you think you're about to read a scholarly dissertation on the ramifications of GILTI, stop right here! For that, I would give a shout out to the outstanding, thorough, and well-written article by Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroain, and Chelsea A. Wood published in *State Tax Notes*.[29] Although I have practiced exclusively in state and local tax for the past 26 years, it looks like I'm going to require refresher lessons in the U.S. taxation of foreign income so I can understand the SALT aspects of GILTI. Although I'm just beginning to identify and understand all the ramifications of this extremely complex — some would argue, overcomplicated — legislation, I believe GILTI is good news for SALT practitioners. After all, GILTI is giving us a new series of deliciously complicated issues to research and analyze, now that *Wayfair* has taken away most of our reasons to argue about what constitutes an actual physical presence in the SALT arena. All SALT lawyers will, by necessity, become international lawyers — perhaps a whole new career path?

If my understanding of GILTI is correct, Congress has decided to pay for part of our popular new federal corporate tax cut by imposing a tax on income U.S. taxpayers earn in low-taxing foreign jurisdictions. A domestic corporation is being taxed on one-half of its GILTI. Most of the states, particularly those whose tax laws conform to the IRC (at least to some degree), are scrambling around trying to ensure they don't inadvertently tax it, too. Most states have adopted a water's-edge policy when it comes to asserting jurisdiction over a taxpayer's income, so it's not that states want to tax GILTI — it's just that conformity states are now forced to go to extremes to carve out the GILTI inclusion amount.

Fortunately for us tax practitioners, GILTI is extremely complicated. Projects are going to get expensive every time I must learn new vocabulary to understand new statutes, but on top of the new definitions, the calculations necessary to compute GILTI are mind-numbing. The federal rules require the "GILTI inclusion amount" to be computed in the aggregate at the U.S. shareholder level for all of a consolidated group's CFCs in which one of the affiliates owns at least a 10 percent interest. The controlled group must then compute its aggregated net tested income and tested loss and subtract from it the deemed return on all of the CFCs' depreciable tangible assets used in the production of tested income — an effort to get at an "intangible income" number. Huh? Section 250 permits those lucky taxpayers a deduction for half of the GILTI inclusion amount to keep the effective tax rate low(er), and there might be a federal foreign income tax credit in there somewhere, which of course, the states won't recognize. Ugh. If the whole purpose of GILTI was to pay for the federal corporate tax cuts, why didn't Congress just decrease the cut a teensy bit more and dispense with all this nonsense?

To make matters worse, GILTI is misleading. As alluded to earlier, when one cuts through the language, Congress labels what it is taxing as "global *intangible* low-taxed income" earned by U.S. shareholders of CFCs, but there doesn't seem to be any limitation of GILTI's application to just intangible income — GILTI can actually include earned or business income supported by valid business purposes that the domestic parents of some CFCs never intended to repatriate! At a recent SALT seminar, one multinational company executive was discussing with me her company's strategy to purchase and invest in foreign manufacturing operations like the parent's, with the intent of using the earnings from those manufacturing facilities for in-country expansion. Her company's leaders believe in capitalizing on the efficiencies of producing goods for sale in the locations where such goods are sold. Why should either the U.S. government or any state be entitled to tax any part of that type of income? Could this type of taxation, in and of itself, violate the foreign commerce clause?

[29] Donovan et al., "State Taxation of GILTI: Policy and Constitutional Ramifications," *State Tax Notes*, Oct. 22, 2018, p. 315.

The draft federal regulatory guidance was disappointing because it did little more than repeat the statutory provisions, and state guidance is dribbling out every week. "Rolling conformity" states are automatically coupled with the IRC, and the GILTI treatment will vary between separate-reporting states and combined-reporting states. The GILTI treatment will vary further among the separate-reporting states, and among combined-reporting states. GILTI operates in a manner like the subpart F federal taxable income inclusion, but will states treat GILTI the same as subpart F income? States that do not tax subpart F income might, nonetheless, tax GILTI unless they decide to treat GILTI as subpart F income and exclude it. Given that GILTI must be aggregated at the consolidated federal level, where does that leave the separate-reporting states? Should GILTI be treated as business or nonbusiness income, and should the CFC's factors be included in a state's apportionment factors if that state taxes GILTI?

Some states have decided to legislatively address these issues, while other states are tackling decoupling through administrative guidance. If separate-return states don't fix the issue, they may face challenges that their taxation of GILTI discriminates against foreign commerce. Some states will include it, and then exclude it through a DRD, while still other states, especially those faced with budget shortfalls, will just tax it. Nonetheless, the extremely fortunate multinational corporate accountants and lawyers will have their hands full in sorting through an entirely new area in which they'll have to separately analyze the laws and administrative guidance of each state to determine how to calculate GILTI and report it at the state level. And there will be taxpayer challenges for any states that try to tax GILTI.

Can you see me smile and hear me laugh? Although GILTI has created a mess for all SALT practitioners, the good news is this mess has created more job security for SALT practitioners!

Not GILTI!

Amy Nogid is counsel in Mayer Brown LLP's New York office.

State tax practitioners are conversant with traditional federal tax acronyms — NOL, AMT, and SRLY are a few that quickly come to mind. After enactment in late 2017 of the TCJA, tax practitioners were introduced to a whole new set of acronyms, including GILTI, FDII, and BEAT. While GILTI may easily roll off the tongue, the clever juxtaposition of words (global intangible low-taxed income) by the TCJA drafters to derive a judgment-laden imposition may have encouraged some states to take an aggressive position regarding how they would treat GILTI for tax purposes. But my answer to the question "Should states treat GILTI as U.S. shareholder income and then subject that income to tax?" is simple: No.

The TCJA heralded a purported shift of the U.S. tax system from worldwide to territorial to encourage companies to locate their businesses (and income) domestically. However, the mere existence of the GILTI provisions belies that purported intent by subjecting to U.S. income tax some foreign income earned by a U.S. shareholder owning 10 percent (vote or value) of a CFC. While the intricacies of the GILTI regime and its computations are beyond the scope of this article, GILTI is also coupled with tax-reduction mechanisms: Section 250(a)(1)(B), which allows a 50 percent deduction (reduced to 37.5 percent for tax years starting after 2025) to effectuate a rate reduction (beyond the across-the-board federal tax rate reductions), and the ability to apply a GILTI-specific FTC. These facts about GILTI should be kept in mind as we saunter back into the state tax world.

Because GILTI is, by definition, income earned outside the country ("global" means non-U.S.), the states' ability to tax *any* GILTI amounts is at best highly questionable and at worst unconstitutional. State tax is inherently territorial — that is, a state is permitted under the commerce clause of the U.S. Constitution to tax only income earned within its borders. Any state's attempt to justify inclusion of some (net of the section 250(a)(1)(B) amounts) or all of GILTI as "displaced U.S. income at least in part"[30] is specious. There is little question that GILTI is really and truly foreign income and there was (and is) no tax-based restriction on where in the world a taxpayer can establish a business. Stated differently, even if a taxpayer makes a business decision to conduct some of its business operations or activities outside the country to save taxes, such decision generally does not constitute tax evasion (bad), just tax avoidance (clearly acceptable, and, in our current president's lingo, makes one "smart").

Even if, *arguendo*, taxing any GILTI could be justified, including GILTI in the state tax base without pairing it with the section 250(a)(1)(B) deduction it was intended to travel in tandem with (that is, omitting the carrot to GILTI's stick), it is improper. If a state opts to conform to the GILTI provisions, at a minimum, an all-or-nothing approach should be the norm.

And perhaps more disturbing is a state's attempt to apportion GILTI (or GILTI net of section 250(a)(1)(B)) without appropriate factor representation. If GILTI is included in the income subject to tax, the factors that generated the income should be considered in the state's apportionment base; that is, the U.S. shareholders' share of the CFCs' factors. For many (if not most) taxpayers, including the CFCs' factors would result in diluting the U.S. shareholders' apportionment factors, possibly reducing their overall state tax liabilities. One novel approach to the apportionment issue is that taken by New Jersey for corporation business tax purposes. The tax on GILTI (net of the section 250(a)(1)(B) deduction) is to be separately computed using the state's relative gross domestic product over the gross nationwide domestic product of the states in which the taxpayer has economic nexus. Huh? Sounds like a true mismatch and — leaving aside the lack of statutory authority, its attempt to impose a rule without abiding by the state's administrative procedure act, and its blatant unconstitutionality under the foreign commerce clause (foreign income cannot be treated differently from

[30] *See* N.J. Div. of Taxation, TB-85(R) (Dec. 24, 2018); Lee A. Sheppard, "Is Taxing GILTI Constitutional?" *State Tax Notes*, July 30, 2018, p. 439 ("displaced domestic income").

domestic income) — wholly unjustifiable. Even if this separate special accounting method results in just a small amount of tax, collecting $1 of tax under an unconstitutional tax regime is unconstitutional.

Sound state tax administration requires sensibility (and constitutionality), even if that sometimes means leaving some potential tax dollars on the table. States should simply say no to trying to tax GILTI, and those that try to shoehorn GILTI into an element of the tax base will likely squander the GILTI-related tax receipts on defending against legal challenges.

GILTI Provides States With an Accidental Windfall

Timothy P. Noonan is a partner in the Buffalo and New York offices of Hodgson Russ LLP.

Should states embrace GILTI? I have to say no. As states confront the impact of the TCJA on their own taxing schemes, the taxation of GILTI has presented somewhat of a conundrum. Most states start with federal taxable income to calculate the tax base for corporations. That means that for most states, GILTI will be in the tax base, unless there is a specific exclusion. The TCJA introduced section 250, which creates a 50 percent special deduction on GILTI income. But as a special deduction, the GILTI deduction does not automatically flow onto a state return in most instances. Thus, absent any action, some states will be taxing 100 percent of GILTI with no deductions or adjustments, leaving states to face two questions. First, should GILTI be taxed at all and, if so, how do (or should) they incorporate the special deduction? Second, if GILTI is included in state taxable income, how does it affect state apportionment?

On the most basic level, GILTI is foreign-derived income, both outside the state and outside the United States. Thus, it has little or no connection with the state trying to tax it. But that lack of connection can be addressed two ways: by excluding GILTI altogether, or through factor relief in apportionment. States that already take a water's-edge approach to taxation, or that can fit GILTI in their definition of subpart F income or foreign dividends, can more easily exclude GILTI from their tax bases. For many states, though, that has required some type of administrative guidance. Connecticut, for example, issued guidance excluding the income, but requiring a 5 percent addback to reflect expenses related to the income. Other states take the position that because there is no legislative exclusion of the income from the base, the best approach is factor relief. Recognizing that the income is not earned in the state, states taking this approach make clear that it is not included in the numerator of the apportionment fraction. New York, for example, issued guidance stating the net GILTI amount (including the 50 percent deduction), unless it is investment income, must be in the denominator of the apportionment fraction not the numerator.

Although there might not be a clear legislative exclusion of GILTI in all states, it makes sense to exclude the income both conceptually and logistically. First, as noted, there is no nexus between the income and the state trying to tax it. For separate-reporting states, there is also likely a constitutional prohibition against doing so. And for the many states that adhere to a water's-edge approach, there should be no rational basis to include GILTI in the tax base. But the real reason lies in the disconnect between the purposes behind federal tax reform and how it applies (accidentally) in many states. The move to a more territorial system and the desire to broaden the tax base is all well and good at the federal level. But it's distressing to see states enjoying the fruits of GILTI and other base-broadening measures without also recognizing the inequity of doing so without a corresponding reduction in tax rates.

GILTI or Not Guilty?

Richard D. Pomp is the Alva P. Loiselle professor of law at the University of Connecticut School of Law.

Who says senses of humor are in short supply in Washington? Whoever came up with GILTI certainly had one, even if misplaced. GILTI reminds us (as if we needed further reminding) just how the state tax world has become an increasingly difficult place to navigate. Not surprisingly, the major accounting and tax firms have increased their stable of tax lawyers and accountants to deal with the so-called Tax Cuts and Jobs Act.

If GILTI were not difficult enough to cope with on just the federal level, its interaction with a state corporate income tax takes that difficulty to new heights (or depths). As a lifetime proponent of worldwide combined reporting, I should be a natural ally of those pushing the states to conform one way or another with GILTI. But as someone who has been drawn into the weeds, my natural enthusiasm for anything that moves a state closer to worldwide combined reporting has been somewhat tarnished.

A legislator being introduced by staff to GILTI cannot help but be predisposed to adopting it. It is hard not to favor adopting a provision to deal with the shifting of profits abroad. But despite the name, not all GILTI is abusive tax haven income. The calculation of GILTI is complicated and can capture legitimate manufacturing and financial services. Perhaps that is an acceptable price to pay for shutting down more egregious games.

Not all states, however, can tax GILTI, despite what their legislatures might want. They have to abide by that pesky U.S. Supreme Court. True, it would be easier for a state to do what it wants without any constraints by the Court, but the U.S. Constitution anticipated that natural predisposition with a supremacy clause and a foreign commerce clause. Add to these constraints the Court's *Kraft* case, which prevented Iowa from discriminating against foreign dividends in favor of domestic dividends, notwithstanding that there was no purposeful intent to do so. Those who want a state to tax GILTI would like to limit *Kraft* to only dividends — the case's actual facts — but that is debatable.

Kraft means that separate-entity states (to be sure, an endangered species) cannot tax GILTI without inviting a quick bench slap in return. (The one exception is if the state were the U.S. corporation's commercial domicile.) And the one mandatory worldwide combined reporting state — Alaska, at least in certain circumstances — will automatically include GILTI as part of the combined group (as well as, quite importantly, the factors of the foreign corporations included in the group).

That leaves the water's-edge states. Unless a state is also the commercial domicile of the U.S. corporation, GILTI can be taxed only if a unitary relationship exists between the GILTI foreign corporation and the U.S. taxpayer. At the extremes, the existence of a unitary relationship may be an easy yes or no. For everything in between, however, we have an intensive facts and circumstances inquiry, time-consuming and data-driven, which many state tax departments, already understaffed and overworked, are ill-equipped to take on. Moreover, we have little judicial guidance on how to conduct this inquiry with modern complicated and sophisticated foreign structures. International tax planning has changed dramatically since *Barclays.* The MTC could have a key role in advising states, as could national and international organizations.

And then there is something that the Founding Fathers knew well — no taxation without representation. The modern version, factor representation, is worthy of a play by Lin-Manuel Miranda. If a unitary inquiry is complicated, try determining how factor representation should be implemented in a multitiered foreign structure involving just about every entity known to exist —and some that have never been seen before. The Detroit and Augusta formulas may help — but only to a point.

Of course, a legislature may determine that the projected revenue makes it worthwhile for a tax department to deal with all of this complexity (or to simply ignore it). A legislature should give a tax department sufficient funds to hire new personnel to deal with GILTI and the rest of the changes made by Congress in December 2017. But the revenue impact of changes like GILTI is notoriously difficult to accurately predict. And whether these estimates are static or dynamic, they rarely consider how taxpayers will react. Law and accounting firm newsletters, webinars, blogs, private client briefings, and major tax conferences abound with discussions about how to minimize GILTI through restructurings and other planning. (Revenue estimators are lucky that rarely do legislators ask them years after the fact to compare their estimates with what actually occurred.)

One thing is sure. While the actual name of the law that gave us GILTI is NOT the Tax Cuts and Jobs Act, Congress did want the law to create jobs. And we in the SALT world are happy to comply even if we are not the intended beneficiaries of those newly created jobs.

GILTI, or Not GILTI, That Is the Question!

Mark F. Sommer is a member of Frost Brown Todd LLC in the Louisville, Kentucky, office, where he leads the firm's tax and incentives practices.

After the Trump-led federal tax reforms of late 2017, state legislatures, departments of revenue, the accounting profession, and the various state bars have been embroiled in what to do about GILTI at the state level.

The simple answer is to maintain the status quo: Continue to treat foreign-sourced income in the manner and under the means used for decades in each jurisdiction.

The GILTI provisions have caused much consternation, particularly in SALT for global, multinational companies. In an era of ever-increasing complexity and divergency in state tax structures, not to mention differences in enforcement and policy efforts, the status quo should be maintained if possible.

Let's use my home state of Kentucky as an example. A few months ago, the Department of Revenue issued a technical advice memorandum addressing GILTI, KY-TAM-18-02, applicable to tax years beginning on or after January 1, 2018. The DOR is to be commended for trying to get ahead of the GILTI issue in connection with the multitude of tax changes brought about by 2017 federal tax reform, as compounded by significant corporate income tax changes legislated by Kentucky H.B. 487 in late April 2018.

In rather refreshing simplicity, the DOR raised the issue of "what is Kentucky's position on the treatment of GILTI for Kentucky income tax purposes?" And, likely reasoning that year-over-year consistency is preferred in the application of the tax laws, the DOR concluded that one should look to Kentucky's treatment of dividend income, set forth in Ky. Rev. Stat. Ann. section 141.039, and how same is excluded from calculating gross income for Kentucky corporation income tax purposes. Given that Kentucky treats subpart F income as dividend income, GILTI should be treated similarly. Consequently, GILTI is considered nontaxable income for Kentucky corporation income tax purposes.

Seeking to maintain consistency in its interpretation, the DOR also concluded that the IRC section 250 deduction, which allows a corporation with GILTI to claim a deduction against a portion of such income on its federal income tax return, should not apply, and therefore Kentucky would not respect a section 250 deduction. Finally, again furthering consistency, the DOR concluded that actual expenses associated with generating GILTI must be added back per the nontaxable income addback provision of Ky. Rev. Stat. Ann. section 141.039, and that GILTI must not be in the computation of the sales factor for corporation income tax purposes.

So, looking at how Kentucky addressed the issue, GILTI really wasn't controversial or complicated. It was simply looking at concerns driven by the federal tax changes and considering how they affect the Kentucky corporation income tax structure. Because the DOR analyzed and concluded as it did, consistency, year over year, is maintained, clarity in the law is provided, and taxpayers and tax administrators are all on notice as to how Kentucky will interpret the federal-driven GILTI changes.

Kentucky's administrative steps in this regard demonstrate that SALT really is not rocket science; sometimes it's really just about blocking and tackling. Here, based on how Kentucky has interpreted foreign-sourced income over the years, and considering all in the context of how to maintain consistency and fair notice to the taxpaying public, a sound result comes forth. Quite refreshing.

GILTI by Association

Marilyn A. Wethekam is a partner with Horwood Marcus & Berk Chtd., co-chairing the firm's multistate SALT practice.

On December 22, 2017, the TCJA was signed into law. It made sweeping changes to the federal tax structure, affecting both individuals and corporations. More importantly from a corporate perspective, the enactment of the TCJA resulted in a significant shift in both domestic and foreign tax policy. The result was a movement from the taxation of U.S. corporations on their worldwide income to one of a territorial taxation structure; for example, taxing domestic-source income while excluding from taxation most earnings from foreign subsidiaries. For those of us who have spent the majority of our careers in the SALT world, this should sound familiar, because most states have adopted a similar approach of taxing only domestic-source income. Although the goal of the TCJA may have been to move the federal tax scheme to a territorial-based one, several provisions were designed to tax the earnings of foreign subsidiaries. The application or adoption of these provisions at the state level has raised numerous policy and legal concerns. The federal policy reasons for these TCJA provisions appear to fall within one of two broad categories. The first is to generate additional revenue to offset the revenue loss resulting from other provisions of the TCJA. The second is to combat the perceived notion of federal tax base erosion. These policy reasons do not necessarily carry over to the states, as it has not been shown that there are state revenue losses resulting from the TCJA that need to be offset. To the extent there is erosion of the state tax base there are statutory or regulatory mechanisms in place to resolve it.

The GILTI regime[31] is one of three TCJA provisions designed to encourage domestic commerce by penalizing domestic corporations doing business in low-tax foreign countries. It is also the provision that has raised a significant amount of discussion and concern at the state level. Specifically, should the states adopt GILTI, and if adopted, will it pass constitutional muster? For federal tax purposes a low-tax country is one with a tax rate of 13.125 percent or lower. Essentially, under the federal scheme a tax rate of 10.5 percent will be imposed on 50 percent[32] of GILTI and an 80 percent FTC may be taken against the remaining income. First, it is highly unlikely the states will tax GILTI at a lower rate. Second, the vast majority of states, do not provide for FTCs. Thus, the mitigating provisions found at the federal level do not carry over to the states. The result for the states could be a revenue windfall and a likely legal challenge.

While the rationale for GILTI may work at the federal level, its adoption at the state level raises several issues and concerns. Before the enactment of the TCJA, most states evaluated and developed policy regarding whether to include foreign-source income in the tax base. The result of that evaluation was the enactment of water's-edge reporting, a deduction for foreign dividends, the exclusion of subpart F income and section 78 gross-up, as well as the inclusion of the income of foreign entities that have more than 20 percent of their property and payroll in the United States. Thus, except for the few states that continue to require or allow worldwide combined reporting, most state tax schemes have adopted a territorial approach. To tax GILTI appears to turn those policy decisions on their ear. This is particularly true for those states that automatically conform to the IRC because these new provisions are clearly inconsistent with long-stated policy.

More importantly, there are legal concerns with the adoption of the GILTI regime. There are

[31] GILTI is not just intangible income. The formula for calculating GILTI includes a reduction for a normal return (10 percent) on the taxpayer's intangible property at its depreciated value. In theory this should exclude a portion of the entity's income that is attributable to tangible property. Issues arise for a capital-intensive business with older depreciated facilities as well as businesses that have little capital investment, such as service or financial businesses.

[32] Section 250 provides for a 50 percent deduction of GILTI.

several constitutional constraints placed on a state's ability to impose a tax that are not imposed at the federal level. First, a state must have jurisdiction to tax the income, and that taxation must not violate either the commerce clause or the foreign commerce clause. Second, if the state does have jurisdiction, that income must be fairly apportioned to the state. There is a serious question if the state taxation of GILTI would pass constitutional muster. The governing principle in the U.S. Supreme Court's decision in *Kraft*[33] was that a state may not treat foreign operations less favorably than a similarly situated domestic operation. The Court noted that the commerce clause is not violated when the different tax treatment of two categories of companies results solely from the different nature of those business activities and not the location of the business activities. The issue with GILTI is twofold. First, a domestic corporation is not taxed on deemed income from a domestic subsidiary. However, that same domestic corporation would be taxed on the deemed income of a foreign subsidiary. Furthermore, the computation of GILTI is fundamentally different from the computation of a domestic company's income. Thus, one is not dealing with the different treatment resulting from the nature of the business activities, but rather the different treatment is based solely on the location of those business activities. This differential treatment violates the principles enunciated by the Court in *Kraft*. Assuming, for sake of argument, the taxation of GILTI will pass foreign commerce clause muster, the income must be fairly apportioned. There must be some recognition given in the apportionment formula to the income-generating factors. To fail to provide for some factor representation opens the taxing jurisdiction up to a challenge based on the fact that income is being taxed out of all proportion to the business activity in the state. What is appropriate factor representation is open to debate, and is complicated by multitiered foreign entities, the treatment of the section 250 deduction, and states' own definition of "gross receipts."

[33] *Kraft*, 505 U.S. 71.

California: Dragging its Feet on Conformity

Kathleen K. Wright is the director of the SALT program in the School of Taxation at Golden Gate University, San Francisco. In February 2015 she was appointed to a three-year term on the California Board of Accountancy.

Many opinions have been voiced about state conformity to the GILTI provisions enacted under the TCJA (new section 951A). Seemingly everybody has weighed in on whether the states should conform. Tax preparers, when asked about conformity, almost unanimously agree that conformity is always the right answer, and that anything but conformity creates chaos for the preparer. But for GILTI, nonconformity might in fact be the more efficient and viable approach. This brief looks at the result under California law if the state conforms and the result if it does not.

California has not yet addressed conformity — and when it does, it appears it will pick up most of the provisions that are revenue raisers for the state, which would include GILTI. California conforms to the IRC as of January 1, 2015, so the reader can only imagine what return preparation is like for the tax year 2018. Virtually all of the provisions of TCJA are applicable on the federal return, and the state return is based on federal law as of January 1, 2015 (as modified by California — and there are many modifications).

What Is GILTI?

Under section 951A, a U.S. shareholder of any CFC must include in gross income its GILTI in a manner similar to the way it includes subpart F income. The amount is the excess of the shareholder's net CFC-tested income over the shareholder's net deemed tangible income return. Net deemed tangible income return is the excess (if any) of 10 percent of the aggregate of its pro rata share of the qualified business asset investment of each CFC over the amount of interest expense that is considered in determining its net CFC-tested income. The CFC-tested income is then reduced by 10 percent of the qualified business asset investment minus the interest expense considered in determining the net CFC-tested income. This is deemed a reasonable rate of return on tangible property held overseas (and seems to encourage investment overseas, which runs contrary to the purpose of the changes in the international area made by the TCJA). CFC-tested income does not include several items, but most relevant for this purpose is any income considered in computing the corporation's subpart F income.

Section 250 permits a corporate U.S. shareholder a deduction equal to 50 percent of its GILTI inclusion amount (resulting in an effective tax rate of 10.5 percent for as long as the corporate rate remains at 21 percent). Section 960 treats the corporate U.S. shareholder as paying a portion of the foreign income taxes paid by the CFC and allows the shareholder to take up to 80 percent of these taxes as a credit against its GILTI tax liability.

The idea is that after these offsets are accounted for, any remaining GILTI is income that should be taxed in the United States (and the state where the domestic corporation operates). The following example illustrates how GILTI works:

> ABC Corp., a U.S. taxpayer, owns 100 percent of a foreign corporation (DEF Corp.), which is used to hold its patents on a manufacturing process it uses itself and licenses to third parties. The revenue from third-party licensing activity, which is booked in the foreign corporation, is $2 million. DEF has $1 million of tangible property. Hence, the amount of GILTI inclusion is computed as:

ABC share of DEF income	$2,000,000
ABC's share of DEF reasonable return (10% x $1,000,000)	(100,000)
Total	$1,900,000
Less: GILTI deduction	(950,000)
ABC's GILTI income inclusion	$950,000

The result is that U.S. shareholders of a CFC with high income relative to its investment in hard assets (think technology companies and service businesses) are going to be subject to GILTI.

State Conformity to GILTI

Constitutional Issues. California uses mandatory worldwide combined reporting for the unitary group. Income generated from application of the GILTI rules might have been picked up in the year reported for tax purposes. If the CFC is unitary with the domestic parent and the income included in the GILTI computation is business income, it is included in the state return in the year earned. The business income (including the income related to the GILTI provisions) is apportioned in the combined report based on a computation of a combined apportionment percentage. This will probably mean that the GILTI income apportioned to the state may well be taxed at a higher marginal rate than it is taxed for federal purposes, because California does not conform to the section 250 deduction and does not have a FTC offset.

The constitutionality of California's use of worldwide combined reporting has been before the U.S. Supreme Court twice and was upheld in both cases.[34] The Court essentially held that although there was a possibility of double taxation through use of worldwide combined reporting, that alone did not make apportionment unfair.

Nonunitary Foreign Subsidiary. But what if the CFC is not unitary with the domestic parent? Taxing the income recognized under the federal rules that define GILTI may reach too far and subject the state to arguments that it is taxing income earned outside its borders by an entity not doing business in the state. This would violate the foreign commerce clause (which grants Congress the sole authority to regulate commerce with foreign nations) by treating international income less favorably than domestic income.

Other complexities arise if California tries to follow the computations set forth under federal law, starting with the definition of who is the taxpayer. Section 951A is based on the consolidated return reporting group (which California does not recognize). California instead uses the unitary concept, and the unitary group is almost always a very different group of business entities.

Some states that addressed the taxation of GILTI in 2018 have administratively or legislatively concluded that either GILTI is not taxable or the includible amount can be offset by a DRD. Although California could legislatively exclude GILTI from the California base, the state does not have a DRD unless the taxpayer has made a water's-edge election.

The Water's-Edge Election. While California conforms to the IRC as of January 1, 2015, exceptions apply. One such exception is the water's-edge provisions, which uses rolling conformity. Under Cal. Rev. & Tax. Code section 25116, the state automatically conforms to IRC provisions referenced in the water's-edge provisions. California's water's-edge provisions do not incorporate the GILTI provisions or the foreign DRD. Therefore, without conformity California could not recognize this income under existing law.

California's water's-edge provisions are broader than most people think. The water's-edge election does allow the unitary group to exclude foreign corporations from the calculation of business income. An exception to this general rule is a CFC with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current-year subpart F income divided by the CFC's current earnings and profits. This is because subpart F income of a CFC is loosely defined as income from tax-haven countries or income considered to be tax-sheltered.[35]

One way for California to conform to the GILTI provisions under the water's-edge provisions would be to adopt the federal computation, and then add the additional income to the subpart F inclusion amount. Although under federal law, GILTI inclusions do not constitute subpart F income, GILTI inclusions are ultimately treated similarly to subpart F inclusions.

If California chooses not to conform to federal law, then it could decouple from section 951A, or

[34] *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983); *Barclays Bank PLC v. Franchise Tax Board of California; Colgate-Palmolive Co. v. Franchise Tax Board of California*, 512 U.S. 298 (1994).

[35] Cal. Rev. and Tax. Code section 25110(a)(2)(A)(i).

the state could recognize the GILTI inclusion amount as a dividend. Generally, if dividends are paid to the water's-edge combined reporting group from a foreign affiliate not included in the combined report, they are considered income on the water's-edge tax return. These dividends are generally entitled to a 75 percent DRD.[36] To qualify for the DRD, the foreign affiliate must be more than 50 percent owned by the water's-edge group and have an average property, payroll, and sales factor in the United States, which is less than 20 percent. This would remove most of the GILTI from the California base.

Conclusion

Conformity in California is always a time-consuming struggle. However, the amount of time that has elapsed since the state last conformed, coupled with the significance of the changes made by TCJA, should mean that we will see conformity legislation this year. Gov. Newsome has implied that he wants conformity with the revenue raisers in the federal legislation. Therefore, it is probably a safe bet that somehow or someway GILTI will find its way into the California statutes in a way that generates the maximum pickup for the state. ■

[36] Cal. Rev. and Tax. Code section 24411.