

States Should Embrace GILTI Or Pursue an Alternative Path to Fairness

by Brian Hamer



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Law. The views expressed in this article are not necessarily the views of the MTC or its members. The author would like to express appreciation to his colleagues at the MTC — Helen Hecht, Lila Disque, Bruce Fort, and William Barber — for sharing their deep knowledge about tax.

In this installment of Revenue Matters, Hamer discusses why states should treat global intangible low-taxed income as U.S. shareholder income and subject it to tax.

Early in my tenure as state revenue director I participated in two particularly memorable conversations with colleagues. In the first instance, a department lawyer came to my office to tell me that the corporate income tax was a “voluntary tax.” When I questioned his statement, he explained that many global enterprises, by using sophisticated planning techniques, could substantially, if not entirely, avoid taxation. In the second instance, a member of the department’s audit bureau told me about the income tax audit of a large and profitable Illinois corporation he had participated in some years earlier. The audit revealed that the business had paid tax that

was not due, and that the business in fact owed no tax at all. The auditor brought this finding to the attention of the business’s tax department (that is how we do things in Illinois), and was surprised to learn that the company was already aware. When he asked why the company had not sought a refund, the representative explained that it was the company’s policy to always pay some tax to Illinois (but not too much). I don’t remember exactly how my colleague put it, but I came away thinking that the company had decided that it was desirable to in effect make a charitable contribution to the state each year.

During my subsequent years at the department, I observed that many profitable global enterprises largely avoided paying corporate income tax. In fact, more than a third of *Fortune* 100 companies typically paid little or no tax to Illinois. In some cases, this was because a company did little business in the state or because the company had experienced an unprofitable year as reflected in its financial statements. But in most cases, it was due in significant part to corporate arrangements that caused the determination of federal taxable income (on which the state relies) to become disconnected from profitability. That phenomenon of course was not unique to Illinois; it is experienced by every state that imposes a corporate income tax.

To the surprise of many advocates of corporate tax reform, the pro-business 115th Congress, with the enthusiastic support of President Trump, inserted provisions into the Tax Cuts and Jobs Act that were clearly intended to address this problem, perhaps most significantly a tax on what Congress

dubbed global intangible low-taxed income.¹ The question now for states is whether they should do what they generally do and follow the federal government's income tax lead, in this case by treating GILTI as U.S. shareholder income and then subjecting that income to tax. And there is a compelling reason to do so.

GILTI, as defined by the TCJA, is income of U.S. shareholders that have a substantial ownership interest in specific foreign entities.² Basically, it is an amount equal to the net income of a U.S. corporation's controlled foreign corporation,³ less a 10 percent rate of return on the CFC's adjusted basis in tangible property. In other words, income that a CFC claims as its own and exceeds a 10 percent return on depreciable assets is now *under federal law* considered to be the income of its U.S. parent. A related section of the TCJA (IRC section 250) allows U.S. shareholders to deduct 50 percent of their GILTI, which serves to reduce the federal tax rate on that income from 21 percent (the new federal corporate income tax rate) to 10.5 percent. Finally, IRC section 960, as amended, permits U.S. shareholders to claim a foreign tax credit equal to 80 percent of foreign taxes paid on GILTI, which eliminates any federal tax on GILTI if the average foreign tax rate on that income is at least 13.125 percent (because 80 percent of 13.125 percent equals the new U.S. tax rate of 10.5 percent).

Just before approving the act, the Senate released an "Explanation of the Bill" that sets forth the reasons for including GILTI in the tax base of U.S. corporations. First, the statement points to the common practice of global enterprises to shift income from U.S. entities to their foreign affiliates, explaining that "a large portion" of the income these enterprises ostensibly earn abroad is derived from intangible property, that this income is highly mobile, and that in the absence of new "base protection

measures" U.S. corporations would have an incentive to "allocate income that would otherwise be subject to the full U.S. corporate tax rate to foreign affiliates operating in low- or zero-tax jurisdictions." Second, it mentions the "difficult problem" of calculating "intangible income," which it expressed was "both complicated and administratively difficult" to do (presumably by U.S. tax authorities).⁴ A report issued by the House Ways and Means Committee one month earlier expressed similar reasons for corporate tax reform. This report states, in a section captioned "Prevention of Base Erosion," that multinational enterprises have "flexibility to attribute profits to low-tax jurisdictions" because they "can structure transactions between affiliates in a manner that minimizes overall tax liability" and that present law does not "adequately address" the ability of these enterprises to transfer intellectual property from U.S. shareholders to their foreign subsidiaries.⁵

Shortly after the TCJA's enactment, Congressional Research Service economists Jane G. Gravelle and Don Marples in a report to Congress summarized legislative intent in the following way: "One of the major motivations for the 2017 tax revision was concern about the international tax system," and specifically "the loss of revenue due to the artificial shifting of profit out of the United States by multinational firms."⁶

Numerous analyses justify this concern, finding that income shifting by multinational corporations causes very substantial revenue loss to the federal government. For example, the Congressional Budget Office concluded after reviewing recent studies that profit shifting lowers taxable corporate income in the United States by a breathtaking \$300 billion each year.⁷

⁴The explanation is posted on the Senate Budget Committee website. Pages 365 and 366 of the explanation delineate the reasons for including GILTI in the tax base of U.S. shareholders.

⁵H.R. Rept. 115-409, 115th Cong., 1st Sess., Report of the Committee on Ways and Means on H.R. 1, Nov. 13, 2017, at 388-389. This report analyzed an earlier version of the bill that ultimately became the TCJA.

⁶Gravelle and Marples, "Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)," Congressional Research Service, May 1, 2018, at 1. According to the Tax Foundation, "GILTI is supposed to reduce the incentive to shift corporate profits out of the United States by using intellectual property," *supra* note 1, at 5.

⁷Congressional Budget Office, "The Budget and Economic Outlook: 2018-2028," at 127 (Apr. 2018).

¹The TCJA, which was signed into law on December 22, 2017, is P.L. 115-97. The Tax Foundation has published an accessible description of GILTI and other international tax provisions of the act. Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits Under the Tax Cuts and Jobs Act" (May 3, 2018).

²GILTI is codified at IRC section 951A.

³This amount does not include CFC income that is already taxed by the United States, such as income taxed under subpart F of the IRC. See IRC section 951A(c)(2)(A)(1).

Kimberly Clausing has written that by 2015 revenue losses to the U.S. Treasury from income shifting totaled between 27 and 33 percent of the U.S. corporate income tax base.⁸ Thomas Tørsløv, Ludvig Wier, and Gabriel Zucman have concluded that 14 percent of U.S. federal corporate tax revenue is lost because of profit shifting.⁹

What was clear to Congress, moreover, is that traditional tax enforcement methods are entirely inadequate to address this problem. Wielding IRC section 482 and other audit tools, the IRS has attacked income shifting schemes for decades, but the figures cited above indicate that its work has come nowhere close to satisfactorily addressing the problem. This is not surprising. The number and complexity of these schemes, and the complexity of global business generally, overwhelm any bureaucratic response. One common example is questionable pricing arrangements between corporate affiliates involving drug formulas or trademarks. The often-unique characteristics of these intangibles make it extremely difficult for the IRS to identify analogous arm's-length transactions that will persuade courts to look beyond the price set by related parties. But on a more fundamental level, it is fair to say that the IRS has been assigned an impossible task. Because intangible property is incorporeal, multinational corporations can easily locate the intangible property they own virtually anywhere in the world, and of course they frequently select low-tax or no-tax jurisdictions, as both the Senate and the House recognized. Given this reality, it simply is not possible, as the Senate also expressed, for the IRS to stop income shifting. And as a result, multinational corporations have been able to avoid tax — both federal and state — while smaller domestic businesses, sometimes the direct competitors of these global businesses, shoulder a disproportionate share of the tax burden.

Clearly, a structural change to the system of taxing global enterprises was called for, and various components of the TCJA are Congress's

effort to deliver such a change. First is the reduction in the U.S. corporate tax rate from 35 percent to 21 percent, which in theory should lessen the incentive for taxpayers to shift income abroad. Then there are the act's other tools that are designed to either discourage the shifting of income to tax havens or to encourage income-producing activities in the United States, including GILTI as well as FDII¹⁰ and BEAT.¹¹ But many observers are skeptical that these tax law changes will have a major impact on corporate behavior. The CBO, for example, estimates that the act will reduce income shifting by \$65 billion per year on average, only a fraction of the income shifting that has been occurring.¹² Gravelle and Marples in their report to Congress stated that “[b]ased on estimates of elasticities of profit location based on tax rate” the rate reduction will restore only between 0.5 and 5 percent of profits to the United States.¹³ There also is the question whether converting the U.S. tax system from a quasi-worldwide system to a territorial system, perhaps the most significant part of the TCJA, will encourage U.S. corporations to even more aggressively engage in income-shifting efforts because under this new system income purportedly earned abroad will permanently avoid U.S. tax even if it is eventually repatriated.¹⁴

GILTI is the TJCA's most direct tool to address the impact of income shifting. Congress, in effect,

¹⁰ This is the abbreviation for foreign-derived intangible income. As defined by the TCJA, FDII is the share of a corporation's domestic income (after various deductions such as for subpart F income and GILTI) less 10 percent of the value of certain tangible assets located in the United States, which is related to the export of goods and services. This income is taxed at only 13.125 percent (actually 21 percent, but taxpayers are allowed to deduct 37.5 percent of FDII) as an incentive for businesses to maintain intangibles in the United States.

¹¹ This is the abbreviation for the base erosion and antiabuse tax. It imposes a minimum tax on certain multinational corporations that have foreign-source income.

¹² “The Budget and Economic Outlook,” *supra* note 7, at 124. This is a net figure, since the CBO believes that the TCJA may also encourage some profit shifting because the act amends the IRC to exempt foreign dividends from U.S. tax. The CBO explains that the impact of the rate reductions and GILTI will be “modest” because, for example, multinational corporations will continue to find it beneficial to assign their intellectual property to affiliates located in countries with tax rates lower than the United States. *Id.* at 125.

¹³ “Issues in International Corporate Taxation,” *supra* note 6, at 27.

¹⁴ The Joint Committee on Taxation estimates that tax on GILTI (after taking into account the 50 percent deduction) will generate \$112.4 billion between 2018 and 2027, reflecting an expectation that substantial income shifting will continue. See JCT, “Estimated Budget Effects of the Conference Agreement for H.R. 1, The ‘Tax Cuts and Jobs Act’” (Dec. 18, 2017).

⁸ Clausing, “Profit Shifting Before and After the Tax Cuts and Jobs Act,” at 12 (Oct. 29, 2018).

⁹ Tørsløv, Wier, and Zucman, “The Missing Profits of Nations” (Sept. 2018).

determined that a portion of the profits claimed by CFCs does not result from business activity in foreign countries; rather, it is the income of U.S. shareholders earned in the United States and should be reassigned to those U.S. entities. This of course is a departure from the system in which the IRS has the burden of determining whether income that has been sourced by a taxpayer to a foreign country should be reassigned. But as discussed above, history demonstrates that an audit solution will not be successful. So instead, Congress — the party assigned by the Constitution to regulate commerce between the United States and other nations — enacted a rule that it apparently concluded was a reasonable and workable way to address the problem of allocating income that is derived in large part from highly mobile intangible property: Income that exceeds a 10 percent return on the tangible assets of CFCs is the result of domestic activities and therefore will be treated as the income of its U.S. parent. (The Senate’s explanation of the bill characterized this as a “formulaic approach.”¹⁵)

The facts that motivated Congress to act apply equally to the states. Income shifting costs states billions of dollars each year, it contributes to an unfair tax system because only sophisticated global enterprises can engage in such activity, and most importantly — as Congress concluded — some income reported by foreign entities is income of U.S. corporations. By incorporating GILTI into their tax code, states therefore would simply be following the federal government’s lead. Adopting GILTI also promises to reduce, if not end, perpetual battles between tax authorities and taxpayers over where income should be sourced, a particular benefit to states if the IRS elects to curtail its enforcement efforts in this area in the wake of GILTI and in response to declining resources.

GILTI already has been the subject of criticism. For example, Joseph Donovan, Karl Frieden, Ferdinand Hogroian, and Chelsea Wood have written that in some cases, application of the rule created by Congress will pick up income that is, in their view, truly foreign income or income that is not in reality “intangible low taxed

income.”¹⁶ But this criticism ignores the fact that no tax system can perfectly allocate the income generated by complex, unitary enterprises with operations in multiple jurisdictions. As the U.S. Supreme Court has expressed, “every method of allocation devised involves some degree of arbitrariness”¹⁷ and the various means that have been used by states to assign income “are imperfect proxies for an ideal that is not only difficult to achieve in practice, but also difficult to describe in theory.”¹⁸ Critics are free to identify a better solution. The answer, however, should not be to maintain a system that allows multinational corporations to manipulate the amount of their U.S. income by siting their intangible property in low-tax or no-tax jurisdictions or to continue to rely on enforcement tools that have failed to protect state tax bases. If a state concludes that taxing GILTI in the same way as it taxes other corporate income may impose an excessive burden on some industries, it can conform to the 50 percent deduction in IRC section 250, or it can adopt targeted deductions or other adjustments to provide appropriate relief. Alternatively, it can adopt an entirely different tool to address income shifting.

One alternative of course is mandatory worldwide combined reporting. It is an approach that at one time was used by a dozen states and that the Supreme Court has ruled on two occasions comports with the Constitution.¹⁹ Apportionment eliminates any tax benefit to income shifting. Similar to GILTI, it is based on the long-accepted principle that sourcing income of a unitary enterprise is inherently problematic and that such income cannot be associated with a particular geographic location.²⁰ Thirty-five years ago, President Reagan, in response to the

¹⁶ See Donovan et al., “State Taxation of GILTI: Policy and Constitutional Ramifications,” *State Tax Notes*, Oct. 22, 2018, at 315. Some GILTI critics also have argued that because states typically do not allow a credit for foreign taxes paid, state taxation of GILTI would not be targeted to income sourced to low-tax or no-tax countries in the same way that GILTI operates on the federal level. However, if states provided a credit, taxpayers would receive a windfall since they would receive a double credit for the foreign taxes they pay.

¹⁷ *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 182 (1983).

¹⁸ *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 303 (1994).

¹⁹ *Container Corp.*, 463 U.S. 159; *Barclays Bank PLC*, *id.*

²⁰ Interestingly, GILTI is arguably a step toward apportionment because it relies on a formula for allocating income.

¹⁵ Explanation of the Bill, *supra* note 4, at 366.

criticisms of worldwide apportionment expressed by multinational corporations and some foreign governments, directed Treasury Secretary Donald Regan to convene a working group to study the issues surrounding state taxation of global enterprises and to make recommendations. The working group, which consisted of Regan, other senior U.S. government officials, state representatives, and business leaders, agreed that states would not require worldwide reporting but also that the federal government would assist the states in addressing the problem of income shifting and would substantially increase the resources given to the IRS (expressly including additional resources for enforcement of IRC section 482).²¹ Given the failure of subsequent tax compliance efforts, despite the working group's aspirations, state adoption of GILTI offers a solution. If, however, states ultimately decide that taxation of GILTI is not the best approach, or that in some cases it has an undesirable impact that cannot be ameliorated, they may decide to reassess the concessions they made 35 years ago and resurrect mandatory worldwide reporting.²²

Is there a possibility that courts will find that state taxation of GILTI violates the Constitution, presumably because it discriminates in some way against foreign commerce? At least regarding combined reporting states, there are strong arguments supporting the constitutionality of taxing GILTI. Under the TCJA, GILTI is income of U.S. corporations. Consequently, it is within the authority of states to tax. Even if a court viewed GILTI as "inherently" foreign income, state taxation would almost certainly survive a constitutional challenge. By analogy, courts have on multiple occasions upheld the constitutionality of taxes imposed by combined reporting states on

foreign dividends paid to U.S. corporations (although GILTI is not actually a dividend).²³ This is not to say that legal challenges to GILTI will not be forthcoming. But then, virtually every new tax idea is met by a lawsuit.²⁴

What is left then is the question of how states should apportion GILTI to comply with constitutional requirements. Arguably relevant, some courts have ruled that when taxing dividends, royalties or interest received by a U.S. shareholder from a foreign affiliate, states may preclude the U.S. shareholder from including the foreign affiliate's factors in the apportionment formula, suggesting that those courts would reach the same result regarding GILTI.²⁵ More likely, however, courts will require states that tax GILTI to allow U.S. shareholders to take into account to some degree foreign factors since typically the profits derived from intangibles are at least in part derived from activities in foreign countries. The challenge of course is to identify a reasonable way to apportion GILTI, a task that the federal government was not required by the Constitution to undertake when enacting the TCJA.

Fortunately, states can look to a growing menu of apportionment options. The New Jersey

²³ See *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (holding that states may tax the dividends received by corporations from an affiliate operating abroad); *DuPont de Nemours v. State Tax Assessor*, 675 A.2d 82 (Me. 1996); and *General Electric Co. v. Commissioner*, 914 A.2d 246 (N.H. 2006). See also footnote 23 in *Kraft General Foods Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992) (suggesting that combined reporting states may tax foreign dividends).

²⁴ Regarding separate-reporting states, there is a substantial question whether the commerce clause permits them to tax GILTI. But separate-filing states that wish to tax GILTI to address shifting of income to foreign affiliates can (and should) simultaneously adopt combined reporting to address shifting of income to domestic affiliates, a step that most states have already taken.

Walter Hellerstein and Jon Sedon make the point that GILTI may be included in the income of a U.S. shareholder that is not domiciled in the taxing state only if the shareholder is engaged in a unitary business with its CFC or the CFC serves an operational function in the parent's business. See Hellerstein and Sedon, "State Corporate Income Tax Consequences of Federal Tax Reform," *State Tax Notes*, Apr. 16, 2018, p. 187, at 200-202.

²⁵ See, e.g., *In re Morton Thiokol Inc.*, 864 P.2d 1175 (Kan. 1993) (dividends received from a foreign subsidiary); and *Caterpillar Financial Services Corp. v. Whitley*, 288 Ill.App.3d 389 (3d Dist. 1997) (royalty and interest payments received from a foreign subsidiary). Regarding foreign dividends, however, not all courts have reached this conclusion. In *Tambrands Inc. v. State Assessor*, 595 A.2d 1039 (Me. 1991), for example, the court held that the state's taxation of foreign dividends violated the commerce clause because it did not allow the payer's factors to be included in the domestic recipient's apportionment formula. Walter Hellerstein has criticized decisions holding that factor representation is not required in the case of foreign dividends. See Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* (3rd ed. 2007), para. 9.15[4][c].

²¹ The Final Report of the Worldwide Unitary Taxation Working Group (Aug. 1984) cites the contention of "multinational corporations," long since debunked, that "federal enforcement of separate accounting is adequate to protect against any misallocation or shifting of income." *Id.* at 2.

²² The Multistate Tax Commission has adopted a model statute providing for worldwide apportionment, with a water's-edge election to reflect the outcome of the working group's deliberations. There are other ways to address income shifting as well. States can enact legislation to require the income of foreign affiliates generated in countries identified as tax havens to be included in the tax base of U.S. taxpayers, an approach that has been adopted by half a dozen states. States also can tax the dividends they receive from their foreign affiliates or disallow expenses of U.S. shareholders related to income reported by their foreign affiliates.

Division of Taxation just announced that taxpayers may apportion GILTI based on New Jersey's share of national gross domestic product, after taking the 50 percent deduction in IRC section 250 which the state has concluded reflects foreign factors. Alternatively, New Jersey taxpayers may request equitable apportionment if they can show that the apportionment formula based on GDP does not fairly represent their activities in the state, or beginning in 2019 they may choose to apportion their worldwide combined income rather than their water's edge income including GILTI. Maine uses the "Augusta method" to apportion foreign dividends, which takes into account only domestic factors unless the result exceeds taxable income using worldwide combination, a model that seems well suited to apportioning GILTI. Or, states may adopt some other method, so long as the method fairly represents an enterprise's business activity.²⁶

As is often the case when states seek to reform their tax codes, there is no risk-free path. But what is certain is that doing nothing will ensure that many global enterprises will continue to avoid paying their fair share of tax with impunity. ■

²⁶In *Container Corp.*, the Supreme Court stated simply that both the due process clause and the commerce clause require states to use a formula to apportion income that is "fair" and also that the "factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container Corp.*, 463 U.S. 159, at 169.

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