Federal Tax Reform – Impact on 2019 Legislative Sessions: GILTI

Executive Committee Task Force on State and Local Taxation
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Global Intangible Low-Taxed Income (GILTI)

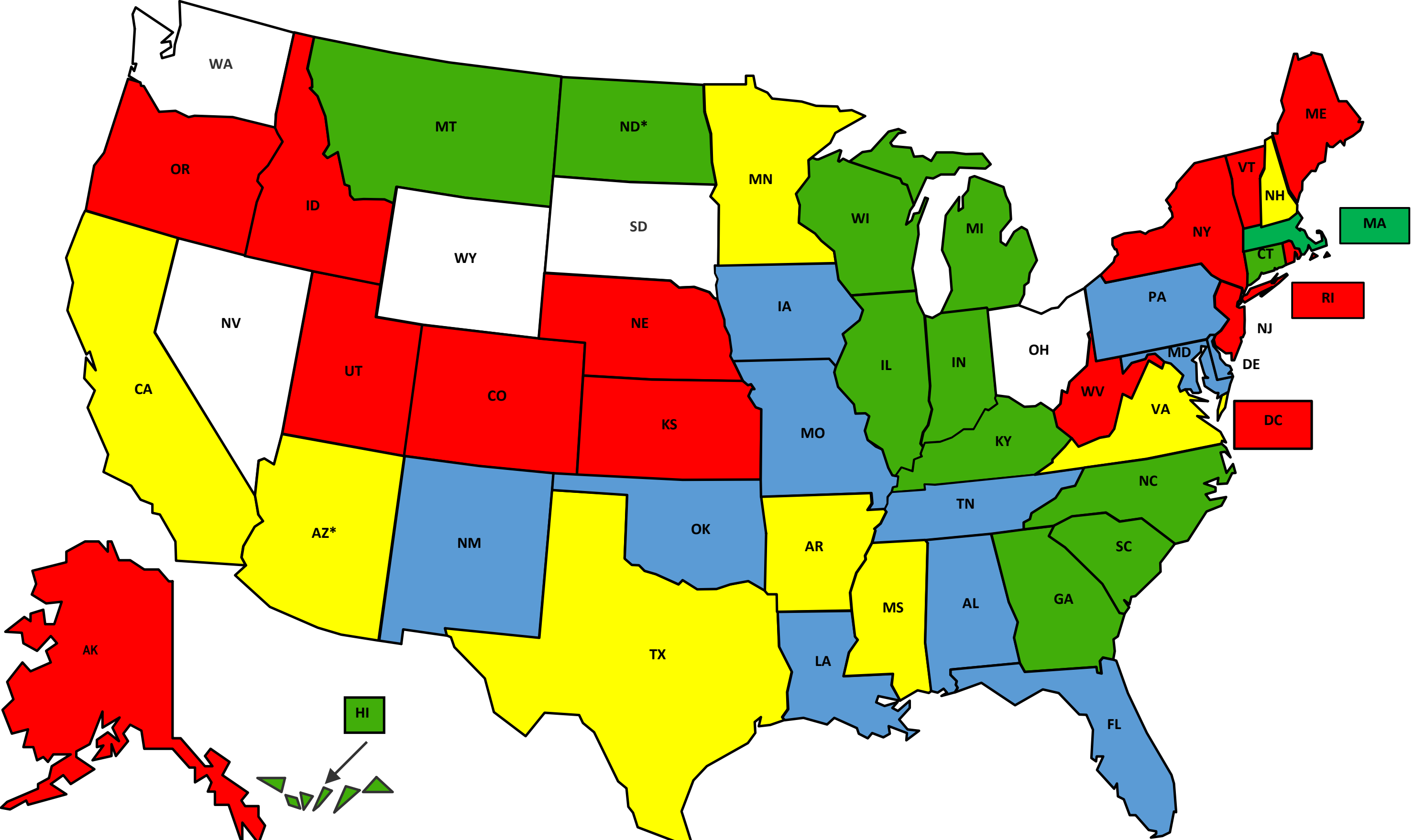
- **GILTI is a new annual federal calculation intended to ensure a minimum tax is paid on worldwide income and is effective in 2018.**
- **Three components are used in the federal GILTI calculation:**
  - **IRC §951A:** Includes all global income earned by the taxpayer's foreign subsidiaries. Makes assumption on how much is intangible based on a set rate of return on tangible assets.
  - **IRC §250(a)(1)(B)):** Provides an offsetting deduction to lower the effective tax rate.
  - **Foreign Tax Credits**: Finally, a credit is provided for 80% of taxes paid to foreign jurisdictions on the GILTI income, which ensures only low-taxed foreign income is subject to federal taxation. Generally, a taxpayer will not be subject to residual U.S. tax if the average foreign tax rate imposed on such income is at least 13.125% (increased to 16.406% in 2026).

Is GILTI Guilty?

- **Global:** Yes, its starting point is all of the global income earned by the taxpayer's foreign subsidiaries.
- **Limited to Intangibles:** This is a misnomer – GILTI includes income from services, digital products, financial services, a sizable portion of tangible property sales, and intangibles.
- **Low-Taxed:** No, the states do not conform to the (80%) foreign tax credit allowed for federal tax purposes to offset the GILTI income. In addition, many of the states may not conform to IRC Section 250 that allows for a 50% deduction for GILTI income.
- **Offset by Corporate Tax Cuts**: No, states do not conform to federal corporate tax cuts (Congress is raising $324 billion over 10 years from the international tax provisions to help pay for $654 billion in business tax cuts).
- **Favor Domestic Commerce over Foreign Commerce:** No, the states are limited by the Constitution's Commerce Clause.

Current Status of State Conformity to GILTI

- **Decoupled from GILTI (or excludes 95%) by legislation or administrative action**
- **Potentially coupled to GILTI, but inclusion is constitutionally prohibited in separate reporting states**
- **Have not addressed I.R.C. conformity and/or GILTI coupling specifically**
- **Coupled or potentially coupled to GILTI***



- Generally, GILTI is not specifically referenced in state conformity statutes so there remains the possibility that some of these states will decouple from some or all of GILTI by administrative guidance (*e.g.*, Kentucky, Connecticut) or future clarifying legislation.

** ND excludes 70% of GILTI

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Source: Council On State Taxation

Kraft precedent: Constitutional Limitations on the State Taxation of Foreign Commerce

- **Separate Reporting States:** See *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992). A separate reporting state may not tax dividends from a controlled foreign corporation if it does not tax dividends from a controlled domestic corporation.
  - Important to recognize that the governing principle was not discrimination against *dividends per se*, but against *foreign commerce*. Thus, under the *Kraft* precedent, the state taxation of GILTI would be similarly prohibited in separate reporting states.
- **Combined Reporting States:** The fact pattern is different for taxing foreign subsidiaries dividends (or GILTI) in combined reporting states because these states include the income and apportionment factors of domestic subsidiaries in the calculation of taxable income.
  - Nonetheless, the taxation of GILTI in combined reporting states likely violates Commerce Clause limitations unless foreign "factor representation" is allowed. Otherwise, the foreign income is discriminated against because its income-generating factors are not taken into account.

Factor Representation: GILTI

- If combined reporting states choose to tax GILTI, but concede it is necessary to offer **factor representation**, what might the apportionment formula look like?
- **Basic principles to follow:**
  - Utilize the **factors of all of the CFC's** and not just the first CFC in a multi-tiered foreign chain.
  - Include the **gross sales** of the CFCs in the denominator of the sales factor, and not just the **net GILTI amount**.
    - Adjust the gross sales as necessary to reflect only the portion of CFC gross sales that are related to GILTI.
  - Combine the foreign gross sales (as adjusted) and other foreign factors (as appropriate) with the domestic sales and other domestic factors and apply to the income of the waters' edge combined reporting group (including GILTI).
- Precedent for this approach can be found in the Multistate Tax Commission's Model Statute for Combined Reporting for factor representation relating to certain categories of foreign source income such as subpart F income or income from so-called 80/20 companies

APPENDIX

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GILTI Calculation Example: Federal vs. State

Item	Federal	State
1. Net CFC Tested Income	$500,000,000	
2. Tested Foreign Income Taxes	$80,000,000	
3. Qualified Business Asset Investment	$1,500,000,000	
4. Net Deemed Tangible Income Return (10% of Line 3)	$150,000,000	
5. Interest Expense Reducing Tested Income	$50,000,000	
6. Excess of Line 4 Over Line 5	$100,000,000	
7. GILTI (Excess of Line 1 Over Line 6)	$400,000,000	$400,000,000
8. Inclusion Percentage (Line 7 Divided by Line 1)	80%	
9. Deemed Credit Paid (Line 8 Multiplied by Line 2)	$64,000,000	
10. I.R.C. Sec. 78 Gross-Up*	$64,000,000	
11. GILTI Plus I.R.C. Sec. 78 Gross Up (Line 7 Plus Line 10)	$464,000,000	

* Line 10 assumes that a state including GILTI in its tax base subtracts the I.R.C. Sec. 78 gross up in conformity with pre-existing treatment at the state level of I.R.C. Sec. 78 gross up.

Source: Council On State Taxation

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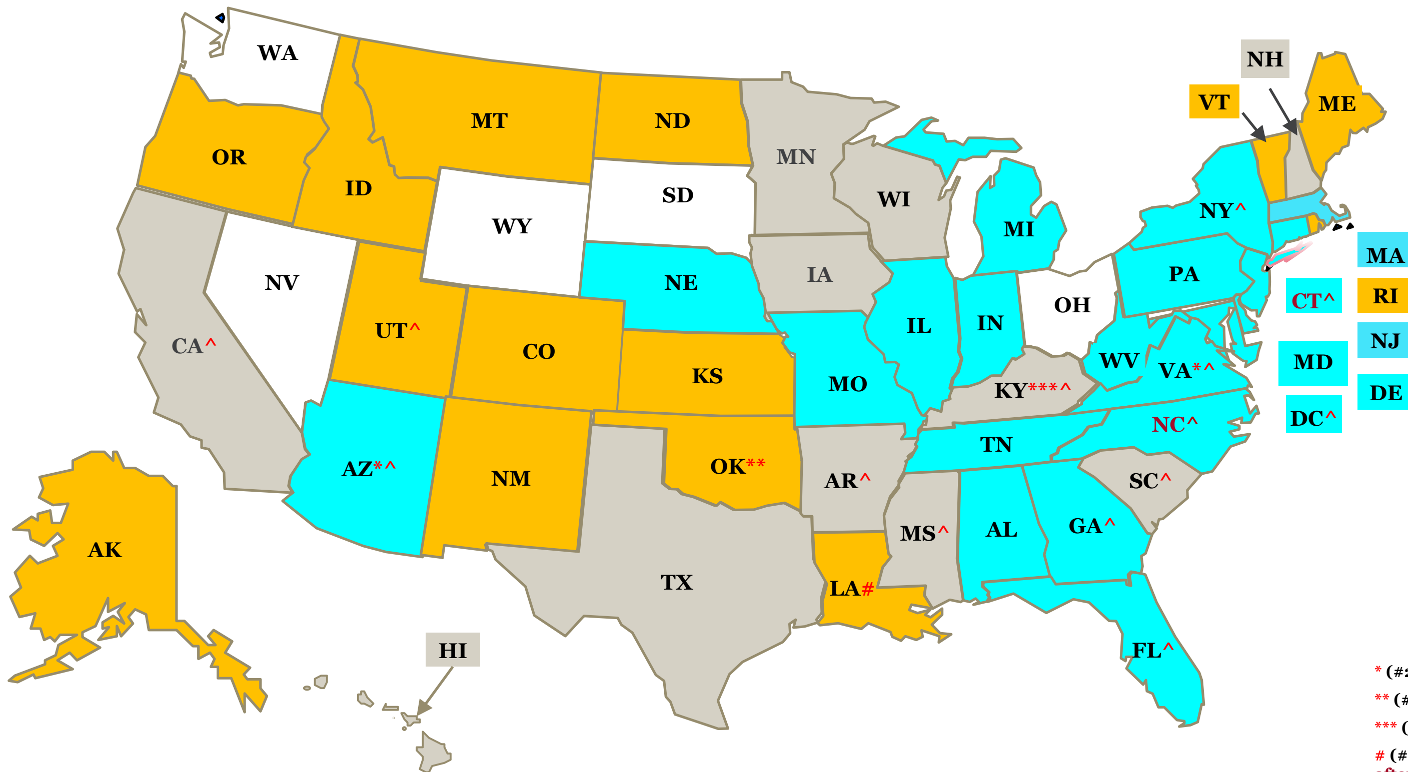
GILTI Calculation Example (cont.)

Item	Federal	State
12. 50% Deduction under I.R.C. Sec. 250 (37.5% beginning in 2026) (Line 11 Multiplied by 0.5) 12a. State: 50% Deduction under I.R.C. Sec. 250 (37.5% beginning in 2026) (Line 7 Multiplied by 0.5)*	$232,000,000	 $200,000,000
13. Net Inclusion in Taxable Income (Line 11 Minus Line 12) 13a. State: Net Inclusion in Taxable Income (Line 7 Minus 12a)	$232,000,000	 $200,000,000
14. U.S. Federal Tax on GILTI (net inclusion) before credits, at 21%	$48,720,000	
15. Less: Foreign Tax Credit (80% of Line 9)	($51,200,000)	
16. Net Federal Tax on GILTI (Unused Foreign Tax Credits Do Not Carryforward)	**$0 Federal Tax**	
17. Unapportioned State Tax on GILTI – Line 13a Multiplied by 7% Tax Rate 17a. State Tax on GILTI Without I.R.C. Sec. 250 Deduction – Line 7 Multiplied by 7% Tax Rate		$14,000,000 $28,000,000
18. State Tax on GILTI, Assuming 20% Apportionment, with I.R.C. Sec. 250 Deduction 18a. State Tax on GILTI, Assuming 20% apportionment, without I.R.C. Sec. 250 Deduction		**$2,800,000 State Tax** **-or-** **$5,600,000 State Tax**

* Line 12a assumes that a state that conforms to the I.R.C. Sec. 250 deduction subtracts any I.R.C. Sec. 78 gross-up added for federal purposes.

Source: Council On State Taxation

965 Transition Tax Conformity for 2017 Tax Year (as of Oct 8, 2018) Source: PwC/COST



* (#2) adopts 965 for 2017, not 2018

** (#1) dividends are allocable; no DRD

*** (#1) adopts 965 for 2018, not 2017

\# (#1) provides a 100% DRD for dividends paid after 7/1/18

^ (#14) expense disallowance provisions attributable to DRDs or exempt income

Based on 100% ownership of CFC

#15	Adopts 965, without 100% DRD or Subpart F modification
#11	Does not adopt 965
#5	No General Corporate Income Tax
#20	Adopts 965, with 95% or more DRD or Subpart F modification

Transition Tax State Issues

- **Will states adopt the 965 (c) tax rate reduction?**
- **Apportionment and factor representation issues.**
  - Over the 30 years encompassed in the mandatory "deemed" dividends period, a U.S. Corporation's footprint in any given state may have changed significantly, and the state's filing method, method of apportionment (3FF, SSF) and tax rate may have changed significantly.
- **Earnings and profits are netted at the federal consolidated group level. This presents unique issues in separate entity states and states where the filing group differs from federal.**
- **If all mandatory repatriated income is excluded, will the state disallow expenses associated with the income?**