Legislators:

Don’t Feel Guilty about Taxing GILTI

NCSL Task Force on State and Local Taxation

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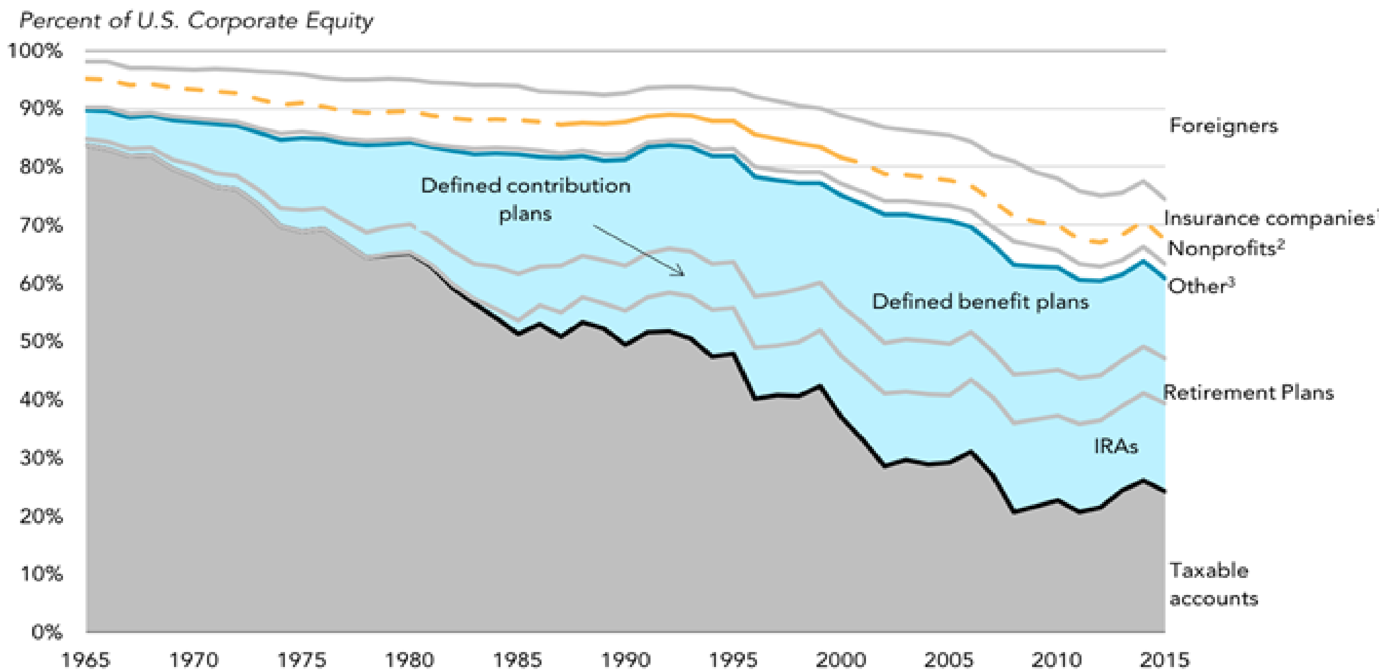
To tax income flowing from the ownership of corporate stock, the federal government and state governments <u>must</u> have a robust <u>corporate</u> income tax.

Most corporate profit can only be taxed at the individual level after a long delay at best

FIGURE 2

Ownership of U.S. Corporate Stock, Direct and Indirect Holdings 1965-2015



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States;" Investment Company Institute. 2016, "The U.S. Retirement Market, Fourth Quarter 2015;" Barclay Hedge; Preqin; Tax Policy Center calculations.

(1) Stock held in non-taxable segregated reserves to fund annuity contracts and whole life insurance.

(2) Dashed lines indicate TPC estimates

(3) Primarily government holdings, but includes equities in 529 savings plans.

In fact, most income from capital ownership is <u>never</u> taxed at the individual level

- Tax Policy Center (9/18):

  "Most capital income earned never is taxed at the individual level, in part because assets are often not sold and their gains never subject to income tax, in part because capital income benefits from a long list of tax preferences, and in part because of outright evasion."

- Study found most wealthy individuals reported annual taxable returns on wealth of less than 2% when actual returns typically averaged 7% or more

- "Because so little capital income is taxed through the federal individual income tax, <u>corporate</u> and estate taxes have been important tools for taxing those with significant wealth."

States are even less able to tax individual capital income than the federal government is

- Vast majority of individual stockholders of corporations doing business in a particular state and benefitting from services that state is providing (skilled workforce, roads, etc.) live in other states and therefore are beyond the individual income tax jurisdiction of that state

- Even state residents owning stock in in-state corporations may only realize that income (from IRAs or in form of capital gains) when they retire in another state; again, beyond taxing power of jurisdiction that provided services that helped generate the income.

- Therefore, states can only ensure that corporate profits generated within their borders are subject to tax if taxed at the corporate level

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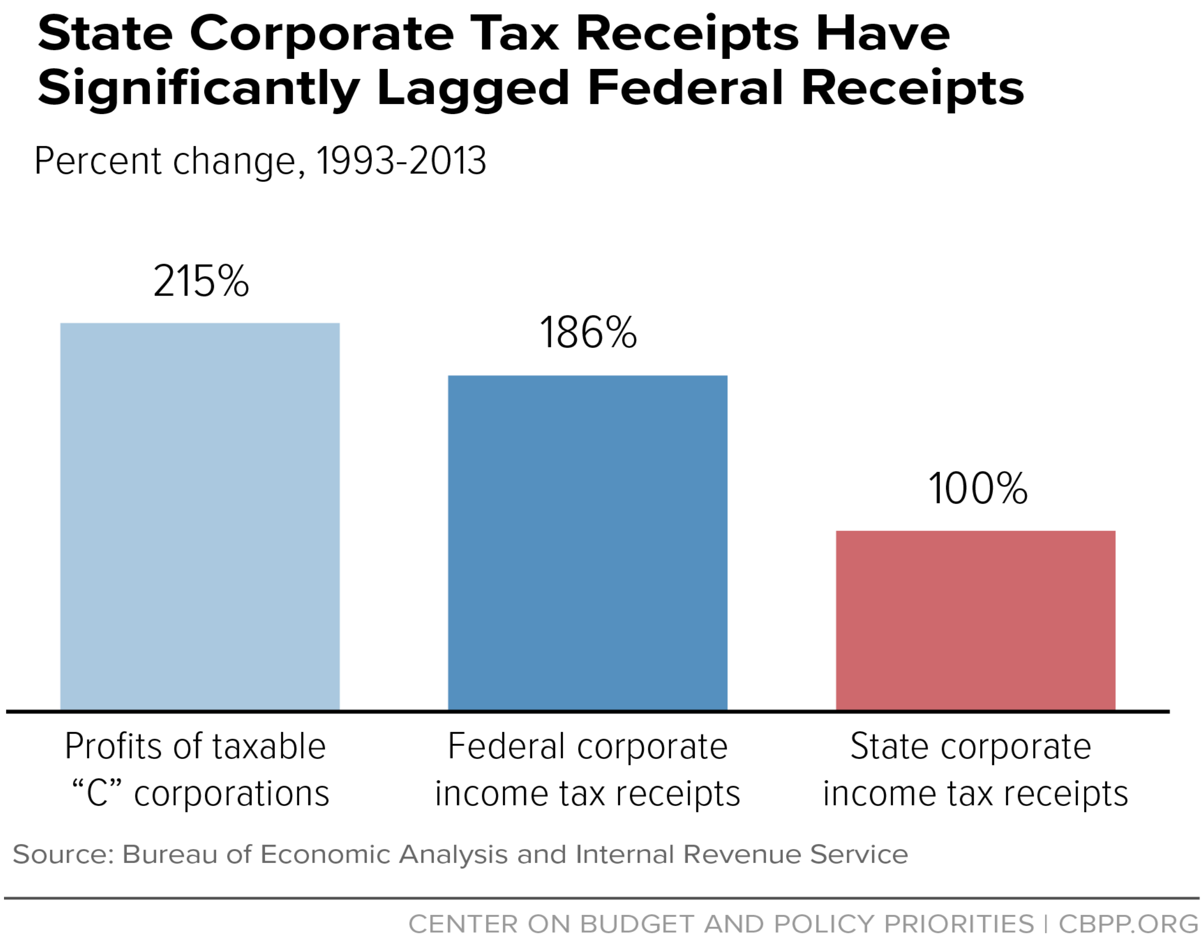
“The federal government has just cut corporate taxes. Why would states raise them now?” Answer:



State vs. federal corporate income tax growth

- Previous graph is limited to “C” corporations, so shift in business activity to passthroughs doesn’t explain it; federal corporate income tax equally affected by shift to passthroughs but federal CIT revenues outpace state

- Large lag in state corporate tax revenues vis-à-vis federal is even more troubling when one considers that many states were decoupled from many large revenue-losing federal corporate tax provisions (e.g., Domestic Production Deduction, bonus depreciation, cap NOLs, etc.)

Abusive international income shifting has been a serious problem eroding both federal and state corporate income tax revenue

- CBO (2018): "Profit shifting also lowers taxable corporate income in the United States—by roughly $300 billion each year, recent estimates from the economic literature suggest."
- Zucman, et. al (2018): 36% of MNC corporate profits earned outside their home countries are reported in tax haven nations; 14% of U.S. federal corporate tax revenue lost due to income-shifting
- Clausing (10/29/18): "By 2015, estimates suggest that revenue losses from profit shifting [by U.S.-based MNCs alone] total an amount between 27 and 33 percent of the U.S. corporate income tax base . . . about $114 billion per year. . . 80 percent of the profit shifting is destined for 7 havens."

Use of international tax havens by household name corporations is widespread

Some examples from corporations with a substantial Oregon presence. In recent SEC 10-Ks:

- Nike reported 39 subsidiaries in the Netherlands, 3 in Singapore, and 1 each in Bermuda and Switzerland.
- Intel Corporation reported 7 subsidiaries in the Cayman Islands and 3 in the Netherlands.
- Columbia Sportswear reported 5 in Switzerland, 2 in Luxembourg, and 1 in the Netherlands.
- 11/15/18 BNA article claims "Corporate America Flees Zero-Tax Caribbean Havens Post Crackdown" for low-tax countries like Ireland and Netherlands that are less of a "red flag."

TCJA anti-income-shifting provisions are unlikely to solve the problem

- Two recent studies estimate that TCJA will prevent only about one-fifth of the U.S. corporate tax base erosion arising from international income shifting:
- CBO: "On net, the . . . changes in tax law will reduce profit shifting by roughly $65 billion per year, on average, over the next 11 years. . . Profit shifting . . . lowers taxable corporate income in the United States. . . by roughly $300 billion each year. . . ."
- Clausing: <u>Lower federal corporate tax rates and GILTI taken together</u> provide disincentives for income shifting by U.S.-based MNCs sufficient to recoup just $19B of estimated $114B annual federal loss from income shifting. <u>But</u>. . .
- "Neither the adoption of territoriality . . . nor the BEAT are modeled here. . . the JCT estimates indicate that territoriality may worsen profit shifting more than the BEAT remedies it."

TCJA anti-income-shifting approach may have uniquely negative impact on states

- Goal of GILTI and BEAT is not "favoring domestic commerce over foreign commerce"; it is deterring abusive income-shifting and recouping some of the revenue lost.
- In their absence, move to territorial system would encourage increased income-shifting, since once income is stripped from U.S. tax base it is gone forever (i.e., no possibility of taxing when repatriated.)
- Attempts to nullify or reduce incentives for income-shifting through GILTI/BEAT/FDII are likely to lead to sharp drop-off in efforts to reallocate shifted profits to U.S. tax base through IRC Section 482 adjustments – the approach that provides the most direct expansion of the state corporate tax base
- Why should IRS expend resources on 482 adjustments when federal treasury is receiving substantial new revenue directly from GILTI and BEAT?
- But states won't reap any such revenue if they accede to corporate community's demand that they not conform to these provisions

State taxation of “foreign source” income (1)

- States can constitutionally only tax income that is earned within their borders; i.e., they must have and always have had “territorial” tax systems
- However, U.S. Supreme Court held ~100 years ago that in measuring taxable income, states can take into account income that is attributable to non-U.S. sales – if it is connected to the same “unitary business” conducted in the taxing state and properly apportioned to activities occurring there.
- All states do that if such income is earned directly by a U.S. corporation.

State taxation of "foreign source" income (2)

- What most states don't do is fully include "foreign source" income in their tax bases on a current basis if it is earned by a non-U.S. corporate subsidiary
- But many states partially include it one way or another (partial taxation of dividends, Subpart F income, etc.)
- And, until Reagan Administration forced them to back off, 12 states fully included "foreign source" income in their apportioned tax base through worldwide combined reporting (WWCR)
- Moreover, even the Reagan WWCR Working Group recognized (pp. 30, 51) that states had the right to tax income shifted to foreign tax havens in what would otherwise have been "water's edge" combined reporting groups
- It is therefore simply untrue that state decisions to conform to GILTI, BEAT, and transition tax provisions of TCJA would represent "a sharp departure from the historic limited state taxation of foreign-source income" or "moving in the opposite direction" of the federal government's move to a quasi-territorial system

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Past state failure to address international income shifting effectively doesn't justify ongoing failure

- U.C. Davis law professor Darien Shanske:

"It is true that without worldwide combination states have had few tools to combat international base erosion, but the fact that this domestic income has escaped tax for so long . . . does not transmute it into non-domestic income. Periodically, a visiting child leaves a toy at our house. If we do not return it right away, my children take the position that the toy is theirs. This phenomenon is called the endowment effect, and it affects all of us, including apparently [opponents of state conformity to GILTI] as to domestic income stripped out of the U.S. base that has not been taxed for decades and decades."

Corporate community opposes all potentially effective state approaches to mitigating international income shifting

- Corporate community is downplaying scale of international income shifting problem and exaggerating likely effectiveness of new TCJA anti-base-erosion provisions
- Corporate community opposes state adoption of all potentially effective tools in state toolbox that at least partially address the problem:
  - Conformity to GILTI and BEAT
  - Inclusion of foreign subsidiaries doing business in tax havens in otherwise "water's edge" combined reporting
  - Worldwide combined reporting (indeed, COST opposes even water's edged combined reporting)
- Wants states to do what they've been doing since the mid-1980s: rely on ineffective federal international corporate tax policy to protect their tax bases from erosion

GILTI is flawed, but not necessarily biased against multinational corporations

- Several criticisms of GILTI are valid: it is arbitrary, not limited to intangible income, and not always limited to “low taxed” foreign income.
- However, not all its flaws lead in the direction of excessive taxation; e.g., many experts have pointed out that assumption of 10% return on physical assets is overly-generous
- Moreover, many experts have pointed out that far from “favoring domestic commerce over foreign commerce” (which corporate represents assert to bolster their claim that state inclusion of GILTI in state apportionable tax base is per se unconstitutional), GILTI provides incentives to move more productive assets abroad since doing so shelters more income reported in tax havens from GILTI

GILTI is flawed, but states should still include it in their tax bases

- GILTI is federal tax policy; if GILTI is flawed, it is the federal government's responsibility to fix it. In the meantime:

- Professor Shanske:

  "There is thus good reason for states to conform to GILTI in order to protect their corporate tax base as best they can by conforming to the federal tool at hand."

- A substantial share of GILTI does represent income that has been inappropriately stripped from the U.S. tax base and shifted to foreign tax havens

Corporate community has concerns with state GILTI conformity beyond concerns with GILTI itself

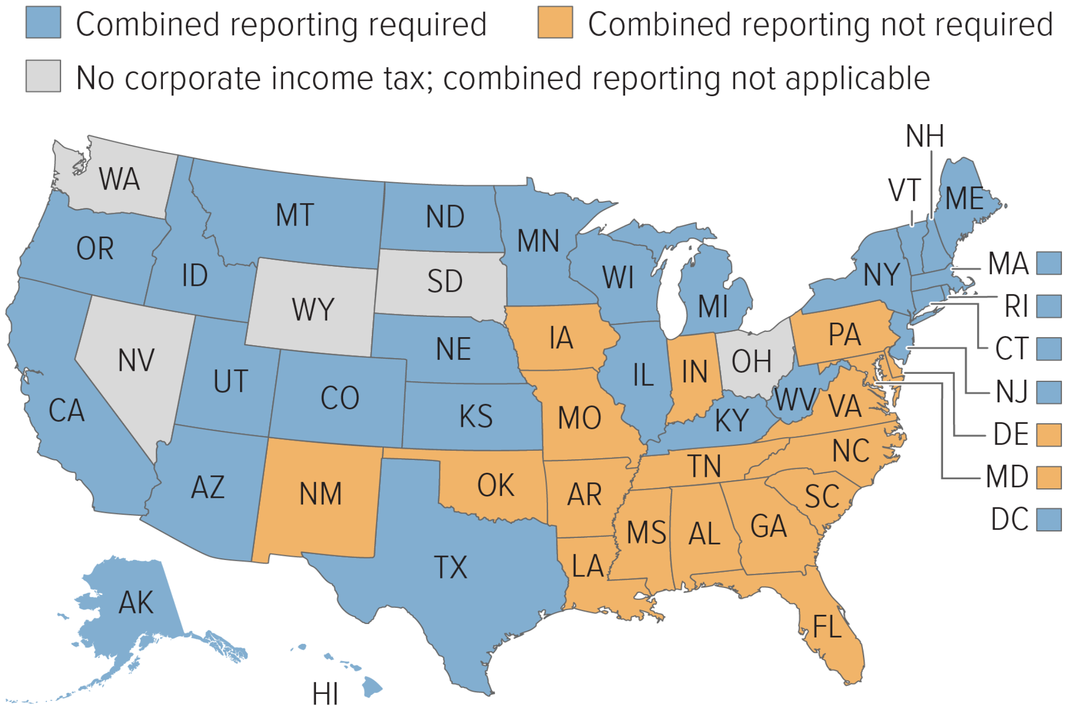
- If states are going to contemplate GILTI conformity, corporate community insists that:
  - No separate entity filing state has legal authority to do so
  - Combined reporting states tax GILTI at half their effective tax rates, as federal government has done
  - Combined reporting states provide "factor representation," i.e., must include property/payroll/sales (as applicable) of foreign subsidiaries generating GILTI
- COST has proposed more detailed principles for such factor representation

GILTI conformity and separate filing states

- Some legal experts (e.g., Shankse, Sheppard) dispute claims that GILTI conformity in separate filing states is necessarily barred by U.S Supreme Court *Kraft* decision (1992)
- We'll very likely find out who's right since corporate community has made clear its intention to bring such litigation if it can't convince all separate filing states to back off from GILTI conformity
- In any case, separate filing states should recognize they likely are losing as much if not more revenue from inter<u>state</u> income shifting as they are from inter<u>national</u>.
- All separate filing states therefore should switch to water's edge combined reporting – as majority of corporate income tax states have now done – at same time they conform to GILTI

A majority of corporate income tax states now require combined reporting

27 States Plus DC Require Combined Reporting for the State Corporate Income Tax



Source: John C. Healy and Michael S. Schadewald, "2018 Multistate Corporate Tax Guide, Vol. 1," Kentucky HB 487 (2018), effective January 1, 2019; New Jersey AB 4262 (2018), effective July 1, 2019.

GILTI conformity in combined reporting states

- Corporate community opposes GILTI conformity by combined reporting states on policy grounds alone (apart from legal objections)
- Even if combined reporting states accede to demands for 50% of normal tax rate on GILTI and factor representation along lines recommended by COST, they will likely still face legal challenges:

> "We focus here on only one potential constitutional infirmity regarding taxing GILTI in combined reporting states, namely the absence of factor representation. Other scenarios may give rise to different constitutional flaws, such as (1) inclusion of GILTI associated with operations that are not unitary with operations of the parent in states other than the commercial domicile of the parent; and (2) failure to give recognition to foreign CFC loss when the same CFC's GILTI would be included and an equivalent domestic loss would be factored into the equation."

GILTI conformity in combined reporting states

- If the corporate community would foreswear legislative opposition and litigation against GILTI conformity in combined reporting states acceding to its demands for some form of factor representation and lower rate, serious consideration of doing so might be warranted.
- But what would be the point of implementing complex factor representation rules when the rules themselves could face legal challenge and when the corporate community is threatening constitutional challenges to GILTI conformity on grounds other than lack of factor representation?
- The one thing states know for certain about their strategies for preventing international income shifting is that worldwide combined reporting (WWCR) is legal as applied to both U.S. and foreign parent MNCs.
- States should therefore mandate WWCR or offer election between WWCR and full inclusion of GILTI in tax base with no factor representation

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“No other country in the world uses combined reporting”

- No other country in the world uses GILTI or BEAT, either
- GILTI arguably is a form of combined reporting; it disregards the separate legal existence of controlled foreign corporations and imposes a minimum tax on their combined incomes
- This argument has been made on the grounds that WWCR is inconsistent with an arms’-length standard approach to international income allocation based on transfer price adjustment
- Leaving aside that this standard has never applied to states and that formula apportionment and the arm’s length approach are fundamentally different allocation systems, the enactment of GILTI and BEAT mean the arm’s length “standard” is effectively dead

State conformity to TCJA's "Foreign Derived Intangible Income" provision

- Regardless of what they do vis-à-vis GILTI, FDII is a revenue-losing tax break that states absolutely should not conform to
- Some experts believe FDII will have little to no effect on U.S. MNC decisions to develop or move intangible assets back to U.S.
- In any case, not appropriate role of state tax policy to try to get them to do so
- States will be giving up revenue with no guarantee the intangible will be developed or managed in the state
- Any intangibles moved back to U.S. will likely be parked in DE, NV, or WY; separate filing states will not benefit at all
- States already layer overly-generous R&D credits on top of federal R&D incentives; no justification for yet another incentive in the form of FDII conformity

Final cautions

- States conforming to <u>any</u> TCJA international provisions (including taxation of “deemed dividends”) can reasonably anticipate legal challenges taking years to resolve

Accordingly:

- States should not build revenue from conformity into budgets; put in rainy day fund or make one-time expenditures instead
- States should not cut taxes in anticipation of an offsetting revenue “windfall” from conformity
- Until their legal authority to conform to TCJA international provisions is firmly established and those provisions are shown to be effective, <u>conforming states should not repeal other tax policies aimed at mitigating interstate and international income shifting</u>, such as mandatory inclusion of tax haven subsidiaries in combined reporting or intangible expense addback requirements (new credits to prevent double taxation may be necessary)

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