

TCJA Issues Relating to Conformity with GILTI, IRC Section 163(j) and Section 118.

**NCSL Executive Committee Task Force on State and Local
Taxation
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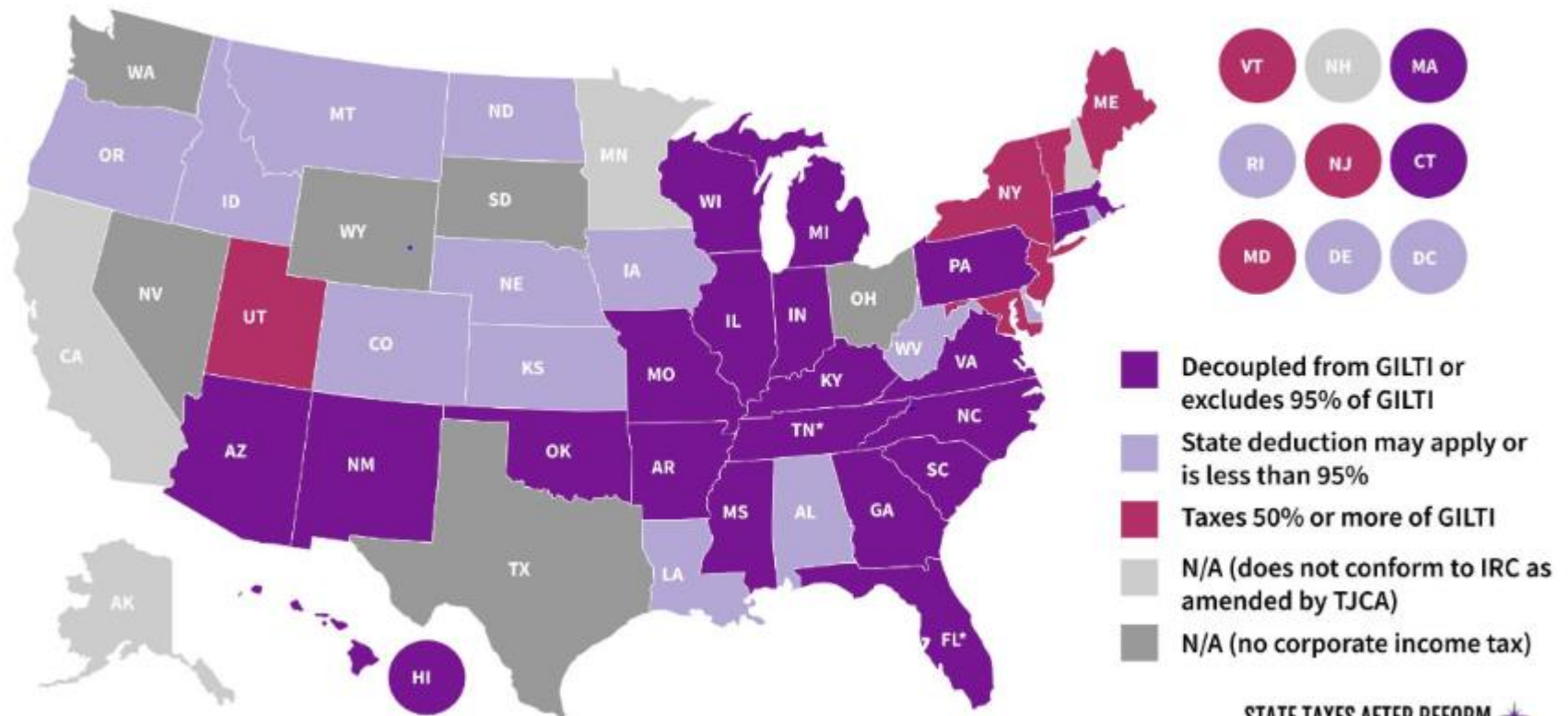
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Are States Conforming with GILTI?

Which states decoupled from the TCJA's **Global Intangible Low-Taxed Income (GILTI)** provisions?



Note: **Tennessee's** bill to provide an exclusion for GILTI has been sent to the Governor but not signed as of May 2, 2019. **Florida's** bill to provide a subtraction for GILTI has been sent to the Governor but not yet signed as of May 6, 2019.

STATE TAXES AFTER REFORM ★
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Why States Should Not Conform to GILTI: The Business Perspective

Why States Should Decouple from GILTI: the State Taxation of GILTI is Different than the Federal Taxation of GILTI from Both a Policy and a Practical Outcomes Perspective

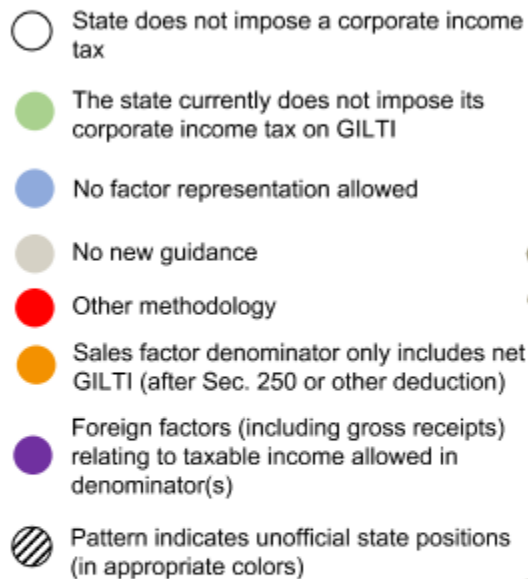
- The state taxation of GILTI represents a sharp departure from the historic limited state taxation of foreign source income.
- GILTI is not “**limited to Intangibles**”. GILTI includes income from services, digital products, financial services, a sizable portion of tangible property sales, and intangibles. For many U.S. multinationals, GILTI constitutes all or substantially all of their foreign source income.
- GILTI (at the state level) is not limited to “**low-taxed income**”. The states do not conform to the (80%) foreign tax credit allowed federally to offset GILTI, and thus tax both low-taxed and high-taxed foreign source income.

Why States Should Decouple from GILTI: the State Taxation of GILTI is Different than the Federal Taxation of GILTI from Both a Policy and a Practical Outcomes Perspective (cont.)

- GILTI at the federal level is intended both to address profit shifting and to **offset the significant federal corporate income 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. **The states do not conform to the federal corporate tax cuts and therefore should not conform to the corporate income tax base broadeners including GILTI.**
 - Importantly GILTI is not income from the *improper* shifting of income overseas.
 - States already have tools to combat improper shifting of the tax base (i.e., related-party addbacks and transfer pricing principles).
- The states are limited by the Constitution's Commerce Clause and **cannot discriminate against foreign commerce** in favor of domestic commerce.
- Business are already paying their fair share of state and local taxes – accounting for about 44 percent of the total state and local tax base. The obsessive focus on expanding the corporate income tax base to include foreign source income ignores the fact that **businesses already pay 42 percent of all sales taxes and 54 percent of all property taxes.**

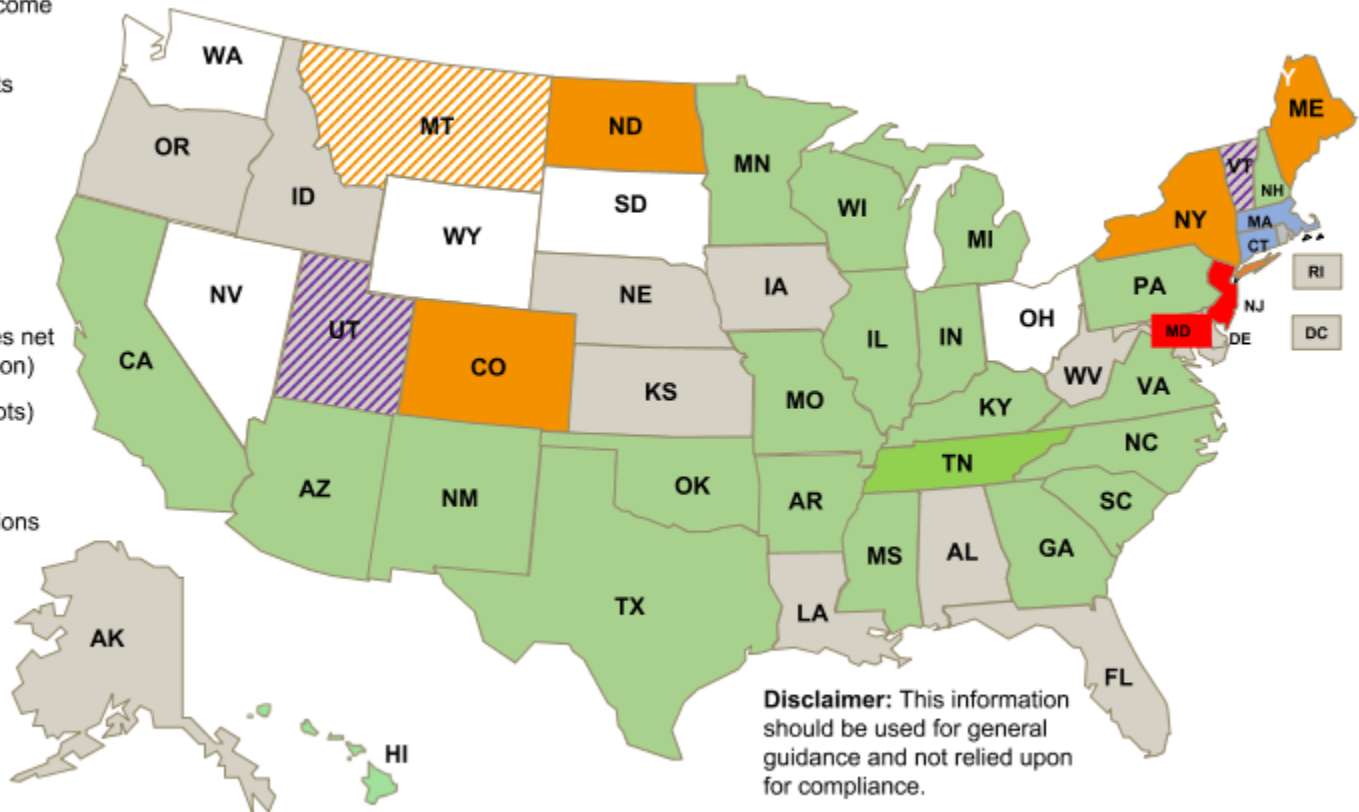
How Are States Applying Factor Representation to GILTI?

GILTI State Factor Representation*



* Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or PIT purposes.

Source: Council On State Taxation



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

How Should States Apportion GILTI and IRC 965 Repatriated Income: The Business Perspective

Factor Representation as a Constitutional Requirement

- External consistency: “... the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.” *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).
- Hellerstein on *State Taxation* (Part IV 9.15): “The factors that are employed to apportion income among the states should reflect the factors that produce the income being apportioned. This virtually axiomatic proposition is also a principle of constitutional law.”

The States Are Deviating from Historical Norms in Limiting Factor Representation for GILTI and IRC §965 Repatriated Income

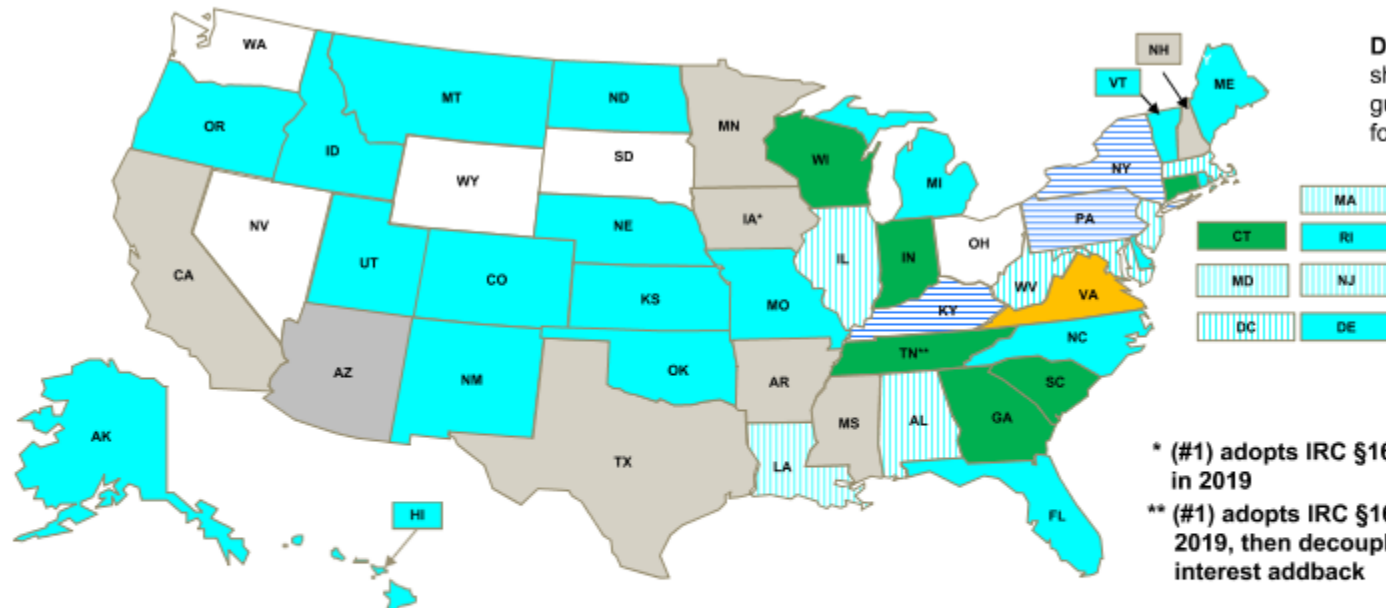
- While attention to date has been focused on state conformity with the new TCJA foreign source income provisions, a less noticed but troubling trend has developed regarding state guidance on the other key element of the state income tax equation: Apportionment.
- **Shockingly, only one of the 18 states taxing a portion of IRC Section 965 repatriated income and of the 22 states taxing some or all of GILTI has provided written guidance that the taxpayer is permitted to include the payroll, property and sales of the foreign CFCs in the denominators of the respective factors.**
- The vast majority of the states are arguably allowing only the **net taxable foreign source income**, and not the gross receipts (or other factors) to be included in the denominators of the respective factors.
 - **This is likely unconstitutional as applied to many taxpayers.**
- This outcome violates the long-standing principle of state income tax apportionment – that the taxpayer's taxable net income in a state is determined by multiplying the taxpayer's total net income by a ratio that consists of the **taxpayer's gross receipts (and other factors where applicable)** in the state over its gross receipts in all jurisdictions.

There Are Clear Precedents for How to Appropriately and Constitutionally Apportion Foreign Source Income

- The approach taken by the Multistate Tax Commission Model Statute for Combined Reporting for factor representation relating to certain categories of foreign source income such as subpart F income or income from designated tax haven countries earned by foreign subsidiaries. In each instance of foreign income inclusion, the MTC model statute includes in the taxpayer's apportionment calculation **“the apportionment factors related to that income.”**
- The “Detroit formula” used by some states and localities for factor relief relating to the taxation of foreign dividends (although 965 income represents 30 years of income so using just current year factors of the CFC would be unfair).
- The method used in all combined reporting states - including both the income of the unitary members of the group and the factors of those same corporations in the combined return.
- These principles will still be complex to administer with GILTI and 965 income – another reason why states should decouple from taxing these new categories of foreign source income.

IRC 163 (j) Interest Deduction Limitation

State Conformity to 30% Interest Expense Limitation



- 5** No General Corporate Income Tax
- 20** Adopts IRC §163(j) as of 1/1/18
- 3** Adopts IRC §163(j) with interest addback related to intangible income
- 8** Adopts IRC §163(j) and has general interest addback provisions

Source: Council On State Taxation

- 6** Enacted Legislation Decoupling from IRC §163(j) [Note – some of these states did not decouple as of 1/1/2018 but decoupled at a later date and some states may still have an intercompany interest expense adjustment]
- 2** Virginia decoupled from 20 percent of the interest expense limitation
- 7** Does not adopt IRC § 163(j) as of 1/1/18

Interest Expense Limitation – IRC § 163(j)

- **General Overview:** Business interest expense cannot exceed 30% of adjusted taxable income (ATI) exclusive of business interest income and floor plan financing
 - ATI is essentially an EBITA (earnings before interest taxes and amortization) concept through 2021 and then EBIT (earnings before interest and taxes) thereafter.
 - Subject to carryforward.
- **State Tax Issues:**
 - Unlike most states, TCJA coupled the interest expense limitation at the federal level to 100% expensing for cost of capital.
 - How is the limitation computed for state purposes when state and federal filing methodologies differ? **When will state guidance be issued?**
 - External vs. internal debt (especially for separate return jurisdictions).
 - Will state allow indefinite carryforward of disallowed interest expense?
 - How will the federal limits interact with state related party interest expense disallowance statutes?

Section 118 Issues

Sec. 118

- Previously, allowed governmental “contributions to capital” not to be taxed.
 - Nor do such benefits typically give rise to tax benefits—such as depreciation.
- Under TCJA –
 - Governmental contributions to capital are taxable.
- Contributions to capital \neq typical tax credits, exemptions, etc.

Why the change?

- On September 7, 2017, Amazon announced it would build a second North American headquarters, saying:
 - “We expect to invest over \$5 billion in construction and grow this second headquarters to include as many as 50,000 high-paying jobs – it will be a full equal to our current campus in Seattle.” The company issued a request for proposals, inviting candidates to describe the possible advantages sites in their area would offer as well as any state, regional, or local incentives that might be provided. More than 200 cities responded, seeking to win what some saw as a competition between the new tech economies and others derided as the “Hunger Games.”

Why the change?

- Less than one month later, on November 3, 2017, the IRS announced a rollout of “11 Large Business and International Compliance Campaigns.” One of these was the “Economic Development Incentives Campaign.” This campaign was apparently prompted by a concern that taxpayers might improperly treat certain government incentives as exempt nonshareholder capital contributions. One commentator theorized that the IRS intended to challenge Supreme Court holdings that location inducements in the form of land contributions and cash grants are non-taxable nonshareholder capital contributions under Section 118 of the Internal Revenue Code.

Why the change?

- A few days later, on November 13, 2017, the U.S. House of Representatives, Ways and Means Committee issued a report on its tax reform proposal. The proposal removed all government incentives and grants from the IRC Sec. 118 exemption for nonshareholder contributions to capital. The report notes:

Why the change?

- “The Committee also believes that removing a special rule that applies only to certain contributions to a corporation by nonshareholders helps achieve the goal of similar treatment of similarly situated taxpayers. The Committee further believes that treating contributions to capital by nonshareholders as income to the corporation will remove a Federal tax subsidy for State and local governments to offer incentives to businesses as a way of encouraging them to locate operations in a particular jurisdiction. If taxpayers in a particular State or locality wish to provide such financial inducements to businesses, they should be able to do so, but they should bear the cost of such financial inducements without passing on a portion of those costs to all Federal taxpayers.”

TCJA generally effective in 2018

- A little over one month later, on December 22, 2017, President Trump signed into law H.R. 1, commonly known as the Tax Cuts and Jobs Act (TCJA). That bill incorporated the Senate's version of the House proposal, treating governmental non-shareholder corporate contributions to capital as taxable income for the first time since the federal income tax was imposed.
- Certain projects in the works were grandfathered.

What does it mean?

- There may be both a federal and a state tax cost *non-tax-related* inducements and other incentives (e.g. cash or property donations to corporations to relocate in the state).
- The exact application and the exact cost depends on the interpretation of what is a taxable contribution to capital (presumably, all old guidance is still relevant) and whether the company will receive a tax-related benefit, such as depreciation, which it would not have received under prior law.

To decouple or not to decouple.

- Things you need to know:
 - The federal government provides similar grants/incentives that will now be taxable.
 - Other states provide such grants/incentives.
 - Companies that receive such grants/incentives are generally subject to tax in multiple states – typically on an apportioned basis.
 - A state that decouples will not keep its own grants/incentives from being subject to federal tax or tax in other states—all it can do is not tax those grants/incentives.
 - It would be highly constitutionally questionable for a state to exempt its own grants/incentives but tax those of other states or the federal government.

Likely constitutional limitations:

- *Boston Stock Exch. v. State Tax Commission*, 429 U.S. 318 (1977)
 - “Our decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. Nor do we hold that a State may not compete with other States for a share of interstate commerce; such competition lies at the heart of a free trade policy. We hold only that in the process of competition no State may discriminatorily tax the products manufactured or the business operations performed in any other State.”
- *Dawson v. Steiger*, U.S. Supreme Ct., Docket No. 17–419 (Feb. 20, 2019)
 - When it comes to taxes that indirectly affect the federal government, states may not discriminate.

Simple Example – all things being equal

- Company X receives a \$1 million taxable grant from both State A and State B.
- Company X apportions 50% of its income to State A and State B.
- Company X is subject to a 20% federal effective rate and to a 10% effective rate in both State A and State B.
- State A decouples from the new Sec. 118
- On its grant from State A, Company X will pay \$200,000 of tax to the IRS and \$100,000 to State B.
- On its grant from State B, Company X will pay \$200,000 of tax to the IRS and \$100,000 to State B.

Result:

- Company X will pay the same tax on both grants.
- But because State B taxes the grants and State A does not, State B can use the tax on the grant from State A to “gross-up” its grant to Company X. This is not unconstitutional under the Supreme Court’s precedent.