

State Taxation of GILTI: Policy and Constitutional Ramifications

by Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroian, and Chelsea A. Wood



Joseph X. Donovan



Karl A. Frieden



Ferdinand S. Hogroian



Chelsea A. Wood

Joseph X. Donovan is Counsel with Sullivan & Worcester LLP; Karl A. Frieden is the vice president and general counsel and Ferdinand S. Hogroian is senior tax and legislative counsel with the Council On State Taxation; and Chelsea A. Wood is an associate with Sullivan & Worcester.

In this article, the authors examine state taxation of global intangible low-taxed income.

Executive Summary

The state taxation of global intangible low-taxed income represents a sharp departure from the historic limited state taxation of foreign-source income and potentially constitutes the largest such expansion in the history of state taxation. Moreover, the state taxation of GILTI is fundamentally different from the federal taxation of GILTI from both a policy and practical outcomes perspective. This article explains the roots of the contradictory state and federal approaches to GILTI and evaluates the intertwined historical, legislative, and constitutional factors that lead to this quandary. Based on this analysis, the authors recommend that states decouple from the GILTI provision — as 13 states have already chosen to do — and that all separate reporting states that conform to GILTI, and combined reporting states that conform to GILTI without factor representation recognize the constitutional infirmity of GILTI inclusion in the state tax base.

I. The Shift in Federal Taxation of Foreign-Source Income

On December 22, 2017, the federal tax reform legislation was signed into law (the Tax Cuts and Jobs Act).¹ For corporate taxpayers, this sweeping federal legislation included a 40 percent income tax rate cut (from 35 percent to a flat 21 percent) and significant shifts in domestic and foreign tax policy. Regarding the taxation of the worldwide income of U.S. companies, the TCJA generally eliminated the taxation of foreign earnings when repatriated (that is, paid as a dividend to U.S. shareholders of controlled foreign corporations).

Instead, U.S.-based multinationals now are allowed a 100 percent dividends received deduction

¹ See Tax Cuts and Jobs Act, P.L. No. 115-97, 131 Stat. 2054 (2017).

for the foreign-source portion of dividends paid by 10-percent-owned foreign corporations.² As illustrated in Chart 1, before federal tax reform, both the combined federal-state corporate income tax rates (the highest among OECD countries) and federal taxation of worldwide income (one of only six OECD countries to do so) made the United States an outlier among industrialized nations in terms of international tax policy.

A. The Global Shift to Territorial Taxation

The shift away from the federal taxation of most foreign-source income aligns the United States with the global movement toward territorial taxation, with its focus on taxing domestic-source income and exempting most of the earnings of foreign subsidiaries. Indeed, the territorial system has rapidly gained popularity over the last 25 years. In 1989 just 10 of 34 OECD member countries had territorial tax systems, and just two of the G-7 countries had this type of tax system. As of 2018, however, 29 of the 34 OECD nations (including most recently the United States) had some form of a territorial system, including all the G-7 countries.³

While the TCJA represents a historic shift in the United States' approach to taxing foreign-source income, the federal government will not completely refrain from taxing foreign earnings. Like other industrialized nations, the United States enacted several more selective provisions designed to tax a portion of the earnings of foreign subsidiaries for the dual goals of raising revenue and combating base erosion.⁴

One of the most important of these selective measures is a new tax on the GILTI of CFCs as that income is earned.⁵ The focus of the GILTI provision is to include in the federal income tax base "low taxed" foreign-source income — essentially, income taxed in foreign countries at less than a 13.125 percent rate. This represents one of several federal

tax reform measures to encourage domestic commerce by penalizing low-taxed foreign operations. To achieve this practical outcome, the federal government imposes a tax rate of 10.5 percent on GILTI (half the federal statutory rate after allowing for a 50 percent IRC section 250 deduction)⁶ and allows a credit for 80 percent of foreign taxes paid on such income.

Other components of federal tax reform that affect the taxation of foreign-source income include a "transition tax" on accumulated foreign earnings,⁷ a tax based on specific related-party transactions (the base erosion and anti-abuse tax),⁸ and a deduction for "foreign-derived intangible income."⁹ These components reflect, respectively, the transition from the deferral regime, a minimum tax to limit specific related-party deductions, and a provision to encourage the location of intellectual property in U.S. entities. However, only GILTI represents an ongoing inclusion in the U.S. tax base of a portion of the current foreign earnings of non-U.S. companies owned by U.S. entities.

B. GILTI Is Just a Name

While the designation "GILTI" may reflect the intent of congressional drafters to address base erosion, the actual components of GILTI belie the name. GILTI is certainly "global," representing the excess of "net CFC tested income" for a tax year over the "net deemed tangible income return" for that tax year, thus including a portion of current (as opposed to repatriated) global CFC income.

However, GILTI is limited to "intangible" income in name only. The formula for calculating GILTI includes a reduction for what is deemed a "normal" (10 percent) return on the taxpayer's tangible property base as measured by its depreciated value. This is intended to exclude at least a portion of income attributable to tangible property.

² IRC section 245A.

³ Karl A. Frieden and Ferdinand S. Hogroian, "State Tax Haven Legislation: A Misguided Approach to a Global Issue," State Tax Research Institute, at 37 (Feb. 2016).

⁴ See, for example, "OECD G20 Base Erosion and Profit Shifting Project, 2015 Final Reports," Executive Summaries, at 13, stating that "30 of the countries participating in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project have CFC rules, and many others have expressed interest in implementing them."

⁵ IRC section 951A.

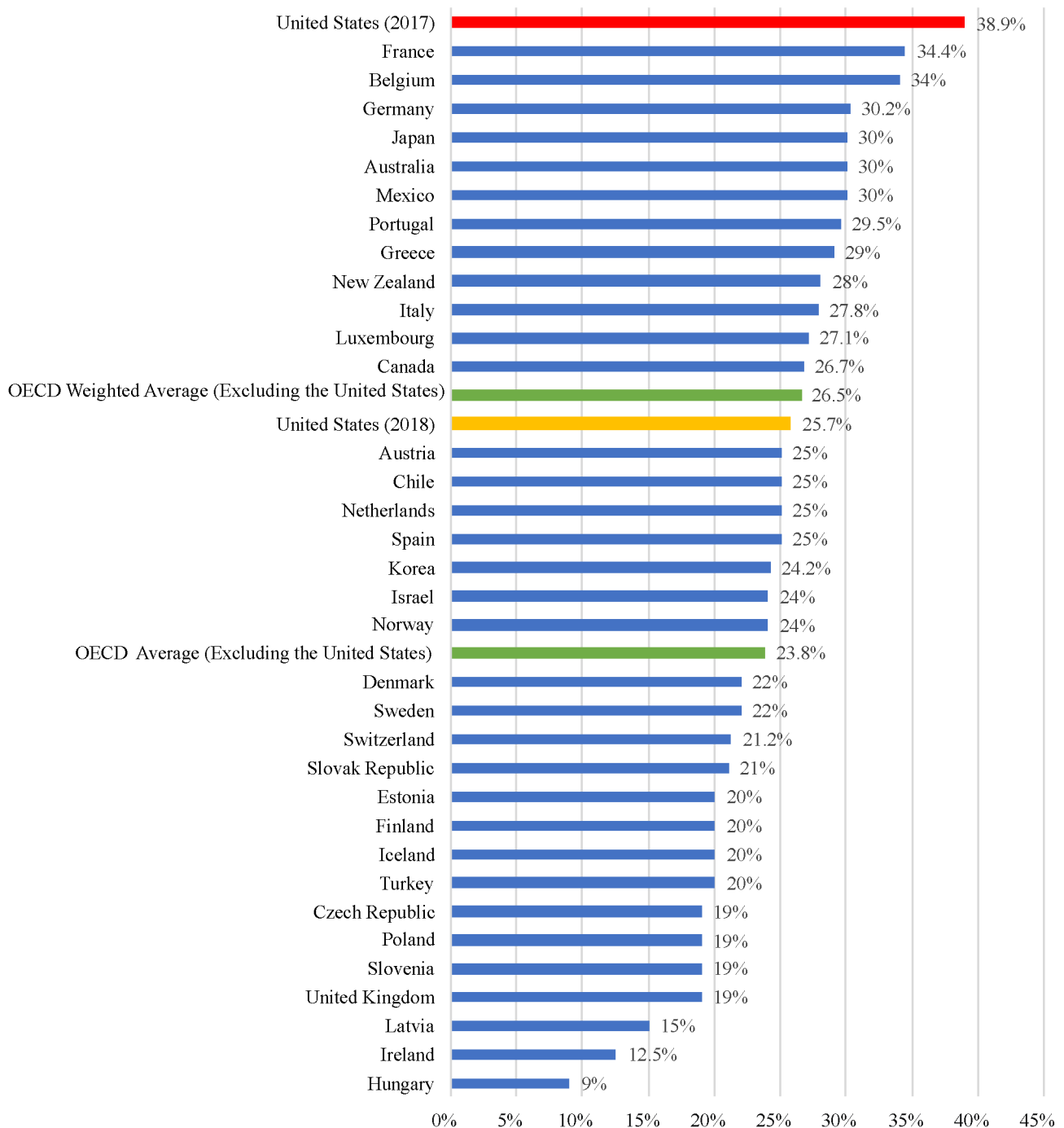
⁶ IRC section 250. The deduction drops to 37.5 percent beginning in 2026.

⁷ IRC section 965.

⁸ IRC section 59A.

⁹ IRC section 250. Under section 250(a), domestic corporations are allowed a deduction for 37.5 percent (reduced to 21.875 percent in 2026) of their foreign-derived intangible income for the tax year. The provision is intended to encourage the location of intangible property in the United States generating income overseas.

Chart 1
Statutory Corporate Income Tax Rates, OECD Nations



Source: The United States Corporate Tax Rate Is Now More in Line With Those Levied by Other Major Nations, by Kyle Pomerleau, Tax Foundation, Feb. 12, 2018, available at: <https://taxfoundation.org/us-corporate-income-tax-more-competitive/>.

There are many businesses, however, with substantial manufacturing and capital-intensive operations overseas but with older (depreciated) facilities. Other businesses operate in an industry that may require limited capital investment, such as service and digital industries and financial institutions. In both instances, GILTI will include not just intangible income, but also most foreign source income earned from selling physical products or providing services. Thus, GILTI is not simply a tax on intangible income — it neither attempts to identify intangible income as such nor makes a defensible approximation by subtracting income attributable to both property and services. Finally, GILTI also sweeps in all intangible-related foreign source income, whether or not the intangibles are located outside the United States for legitimate business purposes.

Regarding low-taxed income, for federal purposes the designation of 13.125 percent as a threshold below which foreign nations' tax regimes are deemed "low taxed" is obviously artificial (although it matches the preferential rate provided to foreign-derived intangible income under federal tax reform).¹⁰ More consequentially for state purposes, the primary federal mechanism for limiting the tax base expansion to low-taxed foreign-source income is the allowance of foreign tax credits, and no state corporate income tax regimes allow such credits. Thus, GILTI will certainly apply to companies with significant amounts of low-taxed foreign income from intangibles. However, GILTI will also encompass a much broader range of foreign source income, particularly at the state level. This point will be discussed in more detail in the next section.

¹⁰ Indeed, the "low taxed" threshold rate will increase to 16.406 percent in 2026 when the IRC GILTI deduction is reduced to 37.5 percent. At the federal level, GILTI has garnered significant criticism for reaching beyond "low taxed" foreign income and purported profit shifting, while containing substantial complexity and inconsistencies with preexisting IRC provisions. See, e.g., Douglas Holtz-Eakin and James Carter, "New GILTI Tax is Killing Private Enterprise, and It Must Be Fixed," *The Hill* (Sept. 17, 2018); Mindy Herzfeld, "Tax Cuts Chaos," *Tax Notes*, Apr. 9, 2018, p. 155.

C. State Conformity and Nonconformity With GILTI

Before evaluating the key policy and practical differences between the state taxation of GILTI and the federal taxation of GILTI, it is important to understand the largely haphazard and convoluted state adoption of or decoupling from the GILTI provision since the enactment of the TCJA. Historically, only a minority of states taxed subpart F income or foreign dividends at all, with those that did generally taxing 25 percent or less of such amounts.¹¹ GILTI introduced confusion into this already opaque area of state taxation. The tax resides in a brand-new code section (IRC section 951A) and is not specifically identified as subpart F income, notwithstanding that section 951A is housed within subpart F (which encompasses sections 951-965) and GILTI is treated in many ways the same as subpart F income. As a result, a substantial number of states that do not tax subpart F income (or foreign dividends) may nonetheless tax GILTI because of the mechanical way state income tax statutes conform to federal taxable income.

To date, 14 "combined reporting" states are coupled or potentially coupled to GILTI because of their conformity to the new federal tax base, either because they are "rolling conformity" states or because they are "fixed date conformity" states that have updated their IRC conformity date (see Chart 3). These states are coupled or potentially coupled to GILTI unless they choose to decouple by administrative guidance or subsequent clarifying legislation. Eleven separate reporting states are potentially coupled to GILTI because of "rolling conformity" or updated "fixed date conformity," but are prohibited under the U.S. Supreme Court's *Kraft* precedent from taxing foreign commerce because they do not tax similarly situated domestic commerce (see Part III). Thirteen states have already decoupled from GILTI by legislation or administrative guidance.

¹¹ See EY, "The Impact of Federal Tax Reform on State Corporation Income Taxes," prepared for the State Tax Research Institute, at 13 (Figure 7) (Mar. 2018). Subpart F income includes some types of so-called "movable income" earned by a CFC and taxable to the CFC's U.S. shareholders in the current tax year.

States that end up decoupling from GILTI based on administrative guidance will likely take a position similar to Connecticut and Kentucky. Those states determined that GILTI is treated in a manner similar to subpart F income for federal tax purposes, and since subpart F income has not historically been taxed in those states, GILTI will not be taxed as well.¹² Finally, 9 states have not yet specifically addressed IRC conformity or GILTI coupling since the passage of federal tax reform. Those include states such as California that have yet to update their conformity with the IRC and therefore do not include GILTI in their tax base and other states such as Virginia that have updated to the changes in federal tax laws only through 2017. In sum, to date over two-thirds of the states have either decoupled from GILTI, are constitutionally prohibited from coupling with GILTI because of their separate reporting filing regimes, or have not yet taken action on federal tax reform conformity (see Chart 2). The final tally of how many states decouple from GILTI is likely to reflect future legislative and regulatory action driven by the policy and constitutional considerations analyzed below.

II. Policy Ramifications: How the State Taxation of GILTI Is Fundamentally Different From the Federal Taxation of GILTI

A. Federal and State Tax Policy on Taxing Foreign-Source Income: Moving in Opposite Directions

As discussed above, with federal tax reform, the government is shifting from its long-standing practice of taxing virtually all the foreign-source income earned by the foreign subsidiaries of U.S. multinational companies, primarily on a “deferred” basis, to taxing a much more limited scope of foreign-source income, including GILTI, on a current basis. This represents a major shift in federal income taxation from a “worldwide”

approach to a quasi-territorial approach. This shift is one of the key underpinnings of the TCJA designed to improve the competitiveness of U.S. businesses by more closely aligning the U.S. corporate income tax rate and tax base with those in foreign countries.

Ironically, the states — at least the ones that end up including GILTI in their corporate income tax base — are moving in the opposite direction, taxing a much wider scope of foreign-source income than ever before. Over the last 30 years, states have generally limited their corporate income tax base to domestic-source income earned by U.S.-based companies — the so-called water’s-edge approach.¹³ From a technical perspective, the water’s-edge approach is calculated primarily by taking into account “the entire income and apportionment factors of any member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States.”¹⁴

To be sure, some states have occasionally ventured beyond the water’s edge to include some foreign-source income in their corporate income tax base. For example, some states include the income of foreign affiliates with more than 20 percent of their factors in the United States. Some states include a special category of foreign-source income called subpart F income in the corporate income tax base. Other states include foreign-source income earned in so-called tax haven countries in the corporate income tax base — although this deviation from the norm has been adopted only in seven smaller states with less than 4 percent of the nation’s population.¹⁵

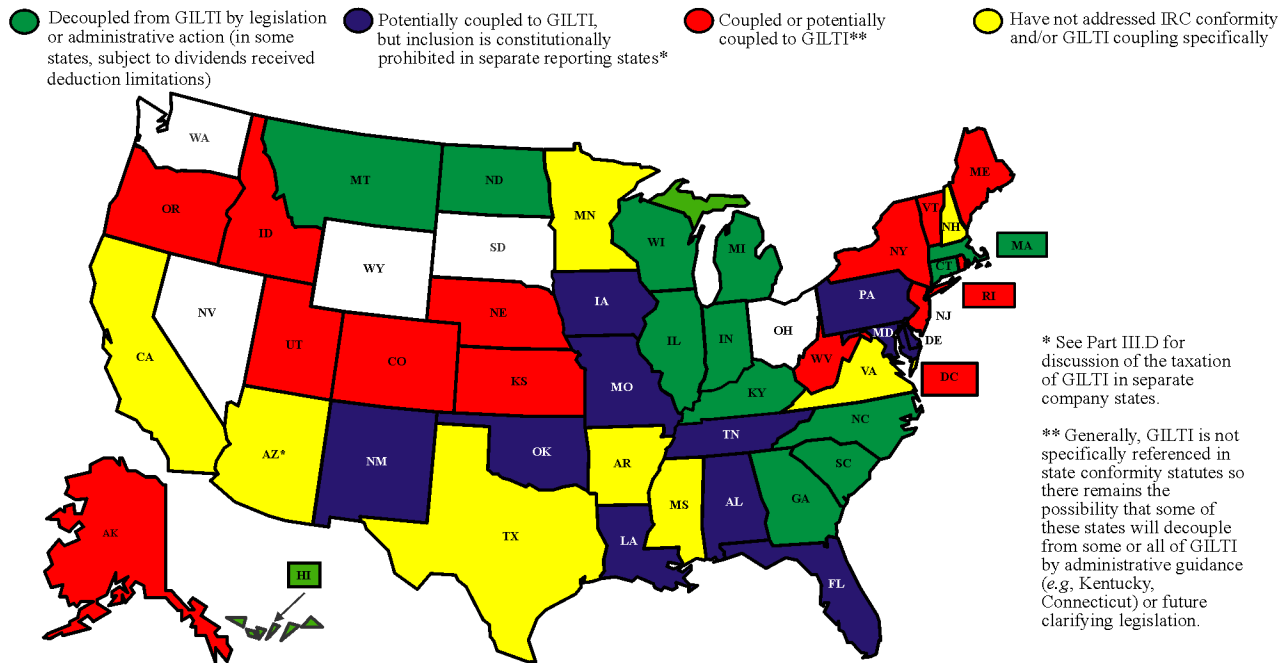
¹² These states include those that decouple from GILTI but subject a portion of it to tax in conformity with their prior dividends received deduction treatment (see, for example, North Dakota’s 30 percent inclusion) and those that include a small portion of GILTI as an expense attribution (see, for example, Connecticut’s 5 percent inclusion). On administrative guidance, see Connecticut Special Notice SN 2018(7) (July 20, 2018); Kentucky Technical Advice Memorandum KY-TAM-18-02 (Aug. 2018).

¹³ On the development of the water’s-edge consensus, see generally Frieden and Hogroian, *supra* note 3, section 3.

¹⁴ Multistate Tax Commission, “Proposed Model Statute for Combined Reporting,” as amended by MTC section 5(A)(i) (July 29, 2011).

¹⁵ Frieden and Hogroian, *supra* note 3, at 8. Note that in 2018 Kentucky adopted combined reporting legislation with a “tax haven” provision, and Oregon repealed its tax haven “blacklist.” Kentucky and Oregon have roughly equivalent populations, and therefore 2018’s legislation does not change this statistic.

Chart 2
Current Status of State Conformity to GILTI



Finally, in the years preceding the TCJA, about one-third of the 46 states with corporate income taxes conformed, in part, to the federal taxation of foreign-source income by taxing a portion of foreign dividends. But even this fact overstates the divergence from the water's-edge orthodoxy, as most of these were limited to Western or New England states that typically included 25 percent or less of the foreign dividends in the corporate income tax base.¹⁶ In total, the fraction of foreign dividend income in the state income tax base was only about one-tenth of what was in the federal income tax base (reflecting both the smaller size of many of the conforming states and the smaller percentage of foreign dividends subject to tax).¹⁷

Thus, since the 1980s, when a small number of states taxing foreign-source income on a worldwide basis (via worldwide combination) pulled back from that approach under pressure from the federal government and some nations, the states have

almost uniformly used a water's-edge approach that generally exempts foreign-source income from the corporate income tax base.¹⁸

Nonetheless, beginning with tax year 2018, states that conform to GILTI will radically transform (and expand) their taxation of foreign-source income. The calculation of GILTI begins with all the foreign-source income of all the foreign subsidiaries of a U.S.-based multinational company.¹⁹ To be sure, there are some important carveouts at the federal level: a deduction for 10 percent of the tangible property tax base and a credit for foreign taxes paid. However, these subtractions are frequently immaterial for many taxpayers (the tangible property base deduction) or not conformed to at the state level (the foreign tax credit).

¹⁶ EY, *supra* note 11, at 13. California has its own method of taxing part of foreign dividends for taxpayers that make a water's-edge election. See *id.* at 12-13.

¹⁷ *Id.* at 18.

¹⁸ See Treasury Department, "The Final Report of the Worldwide Unitary Taxation Working Group," at 1 (Aug. 1984); and Frieden and Hogroian, *supra* note 3, at 31. Some states allow companies to include all their worldwide income in their corporate income tax base, but only by either electing to do so or not electing to choose the alternative water's-edge method. Other than the limited exception of Alaska for oil companies, no state mandates the worldwide combination method.

¹⁹ Under IRC section 957, a "controlled foreign corporation" is any foreign corporation with more than 50 percent of its stock (by vote or value) owned by U.S. shareholders.

international corporate income tax rates. Over the first 10 years of federal tax reform, Congress is raising \$324 billion from the international tax reform provisions (including \$112 billion from the GILTI provision alone) to help pay for \$654 billion in other business tax reform cuts.²¹

The states, by contrast, do not conform to the federal corporate tax rate cuts and therefore have no reason to expand their tax base to make up for the lost revenue. Since the end of 2017 only seven states have enacted corporate income tax cuts to offset the impact of the corporate revenue increases that result from conforming to the base broadeners in the TCJA, and those cuts have typically been modest.²² Thus, adopting the GILTI provisions represents a selective and arbitrary conformity to the revenue-raising federal corporate tax base broadeners in the TCJA without conformity to the offsetting revenue-decreasing corporate tax cuts.

Second, at the federal level, the focus of the GILTI provision is to include in the federal income tax base low-taxed foreign-source income — basically, income taxed in foreign countries at less than a 13.125 percent rate. To achieve this practical outcome, the federal government imposes a tax rate of 10.5 percent (half the federal statutory rate after allowing for the section 250 deduction) on GILTI and allows a credit for 80 percent of foreign taxes paid on such income. However, state corporate income tax laws do not allow foreign tax credits. As a result, all GILTI, whether from low-tax or high-tax countries, is subject to state corporate income tax. This disconnect between federal and state income tax rules simultaneously undermines the intent of the federal legislation to penalize only low-taxed foreign-source income and constitutes a vast and unprecedented expansion of the state

corporate income tax base to include previously untaxed foreign earnings.²³

This outcome is exacerbated in those states that choose to not conform to the 50 percent deduction for GILTI in section 250. About half the states for corporate tax purposes conform to federal adjusted gross income (that is, line 28) rather than federal taxable income (that is, line 30).²⁴ There is still great uncertainty over whether states, particularly those linking to line 28, will conform to the new section 250 deduction.²⁵ Incredibly, if a state includes GILTI in the corporate tax base but does not conform to the section 250 deduction, it may end up with a state corporate tax rate (the average state rate is 7 percent)²⁶ on such income close to the federal reduced rate of 10.5 percent. This is a historically unprecedented outcome. Before the TCJA, the federal corporate income tax rate of 35 percent was five times higher than the average state corporate tax rate.

While the federal government is no longer trying to impose a corporate income tax on U.S.-based multinationals' worldwide income, the states that conform to GILTI would in effect be adopting a slightly modified form of worldwide taxation. Of course, GILTI for state tax purposes

²¹ See "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" the Joint Committee on Taxation, JCX-67-17 (Dec. 18, 2017).

²² States that conform to the base broadening provisions in the TCJA, but not the tax cut provisions, will on average have a 12 percent increase in the state corporate income tax base over a 10-year period. EY, *supra* note 11, at 17. There have been several notable exceptions. The most significant rate cuts include Missouri (H.B. 884, dropping the corporate rate from 6.25 percent to 4 percent) and Kentucky (H.B. 366/H.B. 487, dropping the corporate rate from 6 percent to 5 percent, although the state also adopted corporate base broadeners such as mandatory unitary combination in addition to updating IRC conformity). Iowa reduced its corporate rate significantly (from 12 percent to 9.8 percent), but also repealed the deductibility of federal taxes to offset this change.

²³ While apportionment factor representation is often the state counterpart to the federal use of foreign tax credits, in this case, foreign tax credits perform an additional threshold function (not provided by factor relief) of limiting tax on GILTI to low-taxed income. Furthermore, at this point, it is not even clear that those states that end up taxing GILTI will allow taxpayers "foreign" apportionment factor representation (see discussion of *In re Morton-Thiokol Inc.* and *E.I. du Pont de Nemours & Co. v. State Tax Assessor* in Part III). Before the enactment of the TCJA, the combined federal and state marginal corporate income tax rate was 38.9 percent — the highest among the OECD nations (see Chart 1). Now the federal and state combined income tax rate is 25.7 percent — closer to the middle of marginal rates among OECD nations — and consistent with the goal to make the U.S. rate more competitive from an international tax perspective. Effective tax rates on corporations are frequently lower than marginal tax rates because of different tax deductions, exemptions, and incentives. As a result, U.S. multinationals might end up with GILTI for federal tax purposes from some of the OECD countries with marginal tax rates above 12.5 percent — particularly those with marginal rates close to or less than the new U.S. lower marginal rate. By contrast, because states do not conform to the foreign tax credit, state taxation of GILTI will encompass foreign-source income from virtually all foreign countries — even those with corporate tax rates well above the targeted "low-tax" regimes.

²⁴ EY, *supra* note 11, at 12.

²⁵ Some "line 28" states such as New York and Minnesota have indicated that they will still conform to IRC section 250. *Id.* at 11.

²⁶ With Iowa's lowered rate, Pennsylvania will have the highest state corporate income tax rate, at 9.99 percent. On the average state corporate income tax rate of 7 percent, see Federation of Tax Administrators, "Range of State Corporate Income Tax Rates," as of Jan. 1, 2018.

would first be reduced by a deduction of 10 percent of the foreign subsidiaries' tangible property base.²⁷ However, as noted above, for companies selling services, digital products, financial services, or tangible property with only modest or depreciated plants and equipment outside the United States, this deduction will not significantly reduce the amount of GILTI subject to state taxation. For these companies, GILTI could constitute most or all of their foreign earnings, rebutting any notion that GILTI at the state level somehow is a proxy for displaced domestic-source income.²⁸

Consequently, the taxation of GILTI will frequently have an unintended and arbitrary outcome at the state level compared with the federal level. Although a corporate taxpayer may have no or limited GILTI for federal tax purposes because of the foreign tax credit, the same taxpayer could have significant GILTI at the state level. This is a perverse outcome in conflict with the intent of the U.S. Congress in enacting international tax reform.

Chart 4 illustrates the differences in federal and state calculations of GILTI that in a typical scenario can result in zero additional federal tax liability but a significant additional state tax liability.

C. Addressing Base Erosion at the Federal Level vs. the State Level

While one of the goals of the federal taxation of GILTI and several other related provisions of the TCJA is to discourage base erosion by favoring domestic commerce over foreign

commerce,²⁹ this outcome is much easier to address at the federal level than the state level. First, as discussed above, because states do not conform to the foreign tax credit, they will end up taxing GILTI earned in both high-tax and low-tax countries and on which substantial amounts of foreign taxes have already been paid. Second, as discussed below, constitutional constraints at the state level (but not the federal level) prohibit favoring domestic commerce over foreign commerce. Third, consistent application of the GILTI inclusion at the federal level is possible because there is only one set of federal tax rules, and these can be applied uniformly to U.S.-based multinational companies with foreign subsidiaries. By contrast, the huge variation in rules among the 46 states that impose corporate income taxes — including different filing regimes, different apportionment formulas, different tax rates, and different base-broadening and -narrowing provisions — substantially undermines policy coherence at the state level. Moreover, the fact that base erosion is being seriously addressed at the federal level by means of the new international tax provisions of the TCJA lessens the need for the states to adopt similar measures, particularly when state conformity has so many unintended and adverse consequences.

Indeed, state policy regarding the taxation of GILTI is already off to a very nonuniform start, with half of the states either decoupling from GILTI or constitutionally prohibited from taxing it, another one-fifth having not yet addressed the issue of IRC conformity (see Chart 2), and the likelihood that some will adopt the section 250 deduction while others may not. Individual state efforts to tax GILTI could create a competitive disadvantage with neighboring states that have already decoupled from the provision. This is particularly the case because GILTI targets U.S.-headquartered companies — one of the major generators of economic growth in many states.

²⁷ There is also a deduction for income subject to tax under subpart F.

²⁸ See Lee A. Sheppard, "Is Taxing GILTI Constitutional?" *State Tax Notes*, July 30, 2018, p. 439. Sheppard implies that virtually all foreign source income earned by CFCs and taxed as GILTI is the result of base erosion and income stripping — a startling over-generalization. According to Sheppard, "GILTI represents displaced domestic income. . . . In enacting GILTI, Congress did not believe that the offshored income it acted to claw back is really foreign or alien." *Id.* at 439, 442. In 2017, the companies within the S&P composite index (over 95 percent based in the United States) had aggregate sales of \$10.54 trillion, of which 43.6 percent — or about \$4.6 trillion — were foreign sales. The notion that most (or for some companies "all") of the income earned from these foreign sales should be taxed by the states (under GILTI) because the income is somehow "displaced domestic income" is disconnected from the realities of global commerce. See S&P Foreign Sales Report (Aug. 16, 2018).

²⁹ The preferential tax treatment of foreign-derived intangible income and the preferential amortization treatment of domestic (compared with foreign) research and experimental expenditures are also part of the TCJA effort to favor domestic commerce over foreign commerce.

Chart 4
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. IRC Section 78 Gross-Up^a	\$64,000,000	
11. GILTI Plus Section 78 Gross-Up (Line 7 Plus Line 10)	\$464,000,000	
12. 50% Deduction Under Section 250 (37.5% Beginning in 2026) (Line 11 Multiplied by 0.5)	\$232,000,000	\$200,000,000
12a. State: 50% Deduction Under Section 250 (37.5% Beginning in 2026) (Line 7 Multiplied by 0.5) ^b		
13. Net Inclusion in Taxable Income (Line 11 Minus Line 12)	\$232,000,000	\$200,000,000
13a. State: Net Inclusion in Taxable Income (Line 7 Minus Line 12a)		
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 Carry Forward)	<u>\$0 Federal Tax</u>	
17. Unapportioned State Tax on GILTI — Line 13a Multiplied by 7% Tax Rate		\$14,000,000
17a. State Tax on GILTI Without Section 250 Deduction — Line 7 Multiplied by 7% Tax Rate		\$28,000,000
18. State Tax on GILTI, Assuming 20% Apportionment, With Section 250 Deduction		<u>\$2,800,000 State Tax</u>
18a. State Tax on GILTI, Assuming 20% Apportionment, Without Section 250 Deduction		-or- <u>\$5,600,000 State Tax</u>
^a Line 10 assumes that a state including GILTI in its tax base subtracts the IRC section 78 gross up in conformity with preexisting treatment at the state level of IRC Sec. 78 gross up.		
^b Line 12a assumes that a state that conforms to the IRC section 250 deduction subtracts any IRC section 78 gross-up added for federal purposes.		
Bold font reflects items generally not affecting the state tax calculation. This example is intended to provide a conceptual framework for the GILTI calculation and is not intended to show how the calculation will be reflected on federal and state corporate tax forms.		

It is always problematic to deal with “subnational” corporate income tax rules given the large number of state (and local) taxing jurisdictions. But this problem is significantly exacerbated when the subject is as complex as determining the appropriate amount of foreign-source income to tax and complying with the wildly diverse and evolving rules relating to GILTI. The application of different state apportionment formulas to GILTI — an issue that does not arise at the federal level — may also significantly erode any overriding policy objectives. To date, virtually no state guidance has been issued on how (or even if) apportionment formulas will be adjusted to reflect foreign receipts (and property and payroll) factors relating to generating GILTI.

III. Constitutional Constraints on the Taxation of Foreign-Source Income

A. The *Kraft* Precedent

The touchstone among the cases dealing with commerce clause issues in the context of foreign-source income is, of course, *Kraft General Foods Inc. v. Iowa Department of Revenue*.³⁰ In *Kraft*, the U.S. Supreme Court held that a separate reporting state could not constitutionally piggyback on the federal regime regarding the treatment of dividends insofar as it allowed a 100 percent deduction for dividends received from a wholly owned domestic subsidiary but no deduction for dividends from a foreign subsidiary.³¹ Such discrimination against foreign-source income violated the foreign commerce clause. It was no defense to point out that the Iowa regime did not favor Iowa-source income over other domestic-source income.³² It was also no defense that Iowa’s discrimination against foreign-source income resulted solely from its conformity to the IRC.

³⁰ 505 U.S. 71 (1992).

³¹ The federal regime permitted some corporate taxpayers to take a credit for foreign taxes paid regarding the income that was repatriated via the dividends. Iowa offered no such credit mechanism. *Id.* at 74. Typically, of course, domestic intercompany payments are eliminated for federal tax purposes under the consolidated return rules of IRC section 1502.

³² *Id.* at 78-79.

In the context of the issue we are addressing in this article, it is important to note that there is nothing in the *Kraft* decision suggesting that it is limited in its import to dividends per se. Rather, the governing principle is that a state may not in its income tax structure treat foreign operations less favorably than similarly situated domestic operations.³³

B. Taxation of GILTI in Separate Company States

As of this writing, 11 states that employ a separate company filing method have indicated that they either will or may include GILTI earned by a foreign subsidiary in their tax base, even though they do not tax similar types of income earned by a domestic subsidiary that is not required to file in the state (see Chart 2). Typically, a state with a separate company filing regime does not tax the domestic subsidiary’s income on a current basis and allows a 100 percent deduction for dividends received from wholly owned domestic subsidiaries. For these states to tax GILTI would appear to fly in the face of the Supreme Court’s decision in *Kraft*. So how might the states attempt to sidestep this problem? We can envision them making two arguments, neither of which withstands even cursory scrutiny in our view.

Argument one: “We can’t be discriminating in favor of domestic GILTI because there is no such thing as domestic GILTI!”

It is true that by definition GILTI comprises income of a CFC, so it has no domestic equivalent. But the question under *Kraft* is whether domestic income that is the same in all respects as GILTI receives more favorable treatment than GILTI. Such income generally would be the domestic income of a subsidiary less an amount deemed a return on the tangible assets of the subsidiary. If it were GILTI, it would be deemed the income of its parent and taxed accordingly. Because it is not GILTI, it is not in

³³ Given the breadth of this principle, there are other provisions in the TCJA to which conformity may be susceptible to a foreign commerce clause challenge, including (1) the taxation of the deemed repatriation of foreign earnings under section 965(a) in any state that does not extend its dividends-received deduction to such income, and (2) the rule that research and development activities in the United States give rise to intangible property that is entitled to a faster write-off than intangible property created by research conducted abroad. See IRC sections 965(a) and 174(a)(2)(B).

the income of its parent at all, even if it is distributed. That clearly is a problem under *Kraft*.

Argument two: “*Kraft* dealt only with dividends, and GILTI is not a dividend. And although we treat deemed dividends under subpart F like actual dividends for purposes of our dividends received deduction, GILTI is not a subpart F deemed dividend either!”

This argument misses the point. Yes, because a dividend is defined under IRC section 316 as a distribution out of earnings and profits, GILTI is technically not (or not necessarily) a dividend.³⁴ But as noted above, the broad constitutional infirmity that sank the Iowa regime in *Kraft* was the differential treatment of *foreign-source and domestic-source income*. In *Kraft*, that income happened to be in the parent’s tax base because it was a dividend. If instead of being an actual dividend it was a deemed dividend under subpart F, the same result would occur. And indeed, the states seem to concede this, insofar as they generally do not tax subpart F income if they don’t tax domestic dividends. Also, if instead of being an actual dividend, the income is essentially some or all of the operating income of a CFC (which is what GILTI represents), it is still *foreign-source income* that is being accorded differential (and less favorable) treatment than *domestic-source income* in violation of the *Kraft* precedent.³⁵

Some separate filing states may try to avoid a commerce clause attack on the taxation of GILTI by including some or all of the apportionment factors of the CFC in the overall factor that is applied to the GILTI. But this approach would not be sound, because in those states *none* of the income of a comparable domestic affiliate would be in the apportionment base. Accordingly,

foreign-source income typically suffers a detriment even with factor representation in such circumstances.³⁶

In conclusion, the separate filing states should yield to the *Kraft* principle and concede that GILTI cannot be taxed if they do not tax actual or deemed dividends or GILTI-equivalent income from domestic sources.

C. Taxation of GILTI in Combined Reporting States

What about the taxation of GILTI in combined reporting states? The theory is sometimes advanced that combined reporting states are entitled to include GILTI in the tax base, even without any sort of apportionment factor representation.

This view is grounded principally in the result and the reasoning in two cases in which the highest courts of water’s-edge combined reporting states — Kansas and Maine — held, in effect, that the *Kraft* principle did not preclude inclusion of foreign dividends in the base in those states even without factor representation — *In re Morton-Thiokol Inc.*³⁷ and *E.I. du Pont de Nemours & Co. v. State Tax Assessor*.³⁸

D. The Argument Against Factor Representation in Combined Reporting States

The arguments that prevailed in these two cases are creative and subtle, and essentially identical. They go like this:

Let’s compare two corporations — one a domestic subsidiary of our in-state taxpayer with no operations in our state, but whose operations are integrated

³⁴ And GILTI, likewise, is not literally subpart F income. IRC section 951A.

³⁵ It seems clear that GILTI should be treated as a deemed dividend at least to the extent that it comes out of accumulated earnings and profits of a CFC. Like subpart F income, it creates “previously taxed income” such that when an actual distribution is made of the same earnings, it is not taxed. See IRC section 960(a), (b), and (d). And more fundamentally, if the income was originally earned by a subsidiary and is now attributed to its parent, and there is E&P sufficient to support it, how can it not be a deemed dividend? Will the states that expect to tax GILTI carve out a piece that is not taxed because that piece, if not the whole amount, clearly amounts to a deemed dividend, just like a subpart F inclusion? We see no signs that any state intends to do so.

³⁶ See *Conoco Inc. v. Taxation and Revenue Department*, 931 P.2d 730 (1996), cert. denied, 521 U.S. 1112 (1997), in which the New Mexico Supreme Court rejected the state’s approach in the context of the treatment of ordinary dividends from foreign sources.

³⁷ 254 Kan. 23 (1993).

³⁸ 675 A.2d 82 (1996); see also *General Electric Co. Inc. v. Commissioner, N.H. Department of Revenue Administration*, 914 A.2d 246 (N.H. 2006). Maine law, under the so-called Augusta formula, permitted taxpayers to use a worldwide combination approach in lieu of including foreign dividends if that approach gave rise to a lower tax. The Augusta formula does not provide for factor representation, but rather represents an attempt to limit distortion by compelling the taxpayer to change its filing method to its detriment. See *du Pont*, 675 A.2d 82; *Tambrands Inc. v. State Tax Assessor*, 595 A.2d 1039 (1991); and Maine Tax Alert No. 4 (Sept. 1, 1999).

economically (that is, unitary) with those of its parent, and the other a foreign subsidiary that is otherwise similarly situated. Both corporations have income of \$1,000 during the year in question, and each pays a \$500 dividend to its parent.

Under our state's regime, the foreign-source dividend of \$500 will be included in the tax base and taxed to the extent of the water's-edge apportionment factors of our state. For the domestic subsidiary, on the other hand, all its income — \$1,000 — will be included in the tax base and taxed to the extent of the water's-edge apportionment factors of our state. Therefore, by virtue of the unitary method that we employ, foreign subsidiary earnings actually are taxed more favorably than domestic subsidiary earnings, so there is no unconstitutional discrimination.³⁹

The argument is subtle, but it is also highly misleading, because it leaves out of the equation a key fact that is well known to anyone who has ever modeled combined reporting scenarios. That is, when a corporation is added to a unitary group, its inclusion has two effects: one that tends to increase the tax of the group, and another that tends to decrease it. The first effect is the inclusion of the corporation's income (assuming that it has income) in the taxable base; the second is the inclusion in the denominators but not the numerators⁴⁰ of the apportionment factor values associated with the operations of the corporation. Accordingly, whether the addition of the corporation to the unitary group helps or hurts depends on whether the corporation contributes income to the base that is *disproportionate to the apportionment factor values that it adds to the denominators*.

Morton-Thiokol and *du Pont* seem to have considered only one side of this equation, as if

the addition of the corporation to the group will *always* lead to a higher tax.

This mistake perhaps has its origin in a rather notorious footnote in the majority opinion of the Supreme Court in *Kraft*, footnote 23, which reads:

If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent.

In considering claims of discriminatory taxation under the Commerce Clause, however, it is necessary to compare the taxpayers who are "most similarly situated." A corporation with a subsidiary doing business in Iowa is not situated similarly to a corporation with a subsidiary doing business abroad. In the former case, the Iowa operations of the subsidiary provide an independent basis for taxation not present for the foreign subsidiary. A more appropriate comparison is between corporations whose subsidiaries do not do business in Iowa.⁴¹

The state court decisions in *Morton-Thiokol* and *du Pont* read the language of footnote 23 as implying that the Supreme Court would have reached a different result in *Kraft* had Iowa been a unitary state. First, this is highly speculative,

³⁹See *du Pont*, 675 A.2d, at 87-88 for the actual articulation of this point.

⁴⁰In some instances, of course, as for states employing a "Finnigan" approach to the sales factor, some values will be included in the numerators, but except for such *Finnigan* sales, these values tend to be zero or de minimis.

⁴¹*Kraft*, 505 U.S. at 80 n. 23.

because that set of facts was not before the Court, and the footnote does not expressly say that.⁴² More importantly, perhaps, the language chosen by Justice John Paul Stevens in the footnote suggests that he did not appreciate all the aforesaid implications of a unitary approach — a misunderstanding that perhaps could have been cleared up if the Court had been required to squarely face the issue. And what was the misunderstanding? In the first paragraph of the footnote, Stevens summarizes the comparison of domestic and foreign situations as follows: “Iowa would tax an apportioned share of the domestic subsidiary’s entire earnings but would tax only the amount of the foreign subsidiary’s earnings paid as a dividend to the parent.” This is true as far as it goes, but it does not consider that when one adds a new corporation to a unitary group, not only does a piece of that corporation’s income now get taxed, *the addition of the denominators of that corporation to the overall unitary factor has the effect of reducing the tax on the income of all the other corporations in the group.* And again, that positive effect (from the taxpayer’s point of view) can offset the entire detriment associated with inclusion of the corporation’s income in the pie.⁴³

In contrast, inclusion of foreign dividends in the base without factor representation invariably and obviously increases the tax, so the foreign dividend treatment and the domestic unitary

treatment are by no means “rough justice” equivalents such that a unitary setting cures the perceived commerce clause problem.⁴⁴

It is true, it must be said, that one can imagine a circumstance in which unitary inclusion produces a worse answer than inclusion of the dividend, in a case in which the income of the domestic subsidiary is significant but its factors are not, and all the income of the foreign subsidiary is not paid out as a dividend.⁴⁵ But we regard this as the exception that proves our point that the courts in *Morton-Thiokol* and *du Pont* misapprehended the mathematical consequences of reconfiguring a unitary group, as opposed to simply pulling additional income into the pie.

To illustrate these points numerically, it’s useful to consider three scenarios involving the potential taxation of foreign dividends and of GILTI. In these examples, which we reproduce in the Appendix to this article, we assume an apportionment formula that equally weights property, payroll, and sales,⁴⁶ and a state corporate income tax rate of 7 percent. We also assume that the foreign operations giving rise to foreign dividends or GILTI are unitary with domestic operations.

First, let’s look at a scenario (Example 1) that fits the paradigm of the *Kraft* case itself: a U.S. corporation operating in a separate return state that has two wholly owned subsidiaries — one domestic and one foreign — each of which pays a \$5 million dividend to its parent during the tax year. It’s a simple story on the facts presented — the domestic dividend gives rise to no additional

⁴² In fact, Jerome R. Hellerstein and Walter Hellerstein argue that “*Kraft* footnote 23 has nothing to do with a comparison between a combined reporting regime for unitary domestic subsidiaries and a separate company reporting regime for unitary foreign subsidiaries.” Rather, they say, the footnote “simply points out that under a separate company reporting regime, it is more appropriate for purposes of discrimination analysis to compare apples with apples (*i.e.*, the ‘aggregate tax’ imposed by Iowa with respect to a unitary domestic subsidiary *not doing business in Iowa* and a unitary foreign subsidiary *not doing business in Iowa*) rather than apples with bricks (*i.e.*, the ‘aggregate tax’ imposed by Iowa with respect to a unitary domestic subsidiary *doing business in Iowa* and a unitary foreign subsidiary *not doing business in Iowa*).” (emphasis in original) See Hellerstein and Hellerstein, *State Taxation* para. 4.22[1][b][iv].

⁴³ See Example 2 in the Appendix.

⁴⁴ See *Tambrands Inc.*, 595 A.2d 1039 (holding that Maine’s unitary business formulary apportionment method was unconstitutional when the dividends from the foreign affiliates were included in apportionable business income, but it did not include at least a portion of the property, sales, and payroll factors of the foreign affiliates); *Emerson Electric Co. v. Tracy*, 735 N.E.2d 445 (Ohio 2000) (finding that Ohio’s requirement that deductions for foreign dividends, but not domestic dividends, be reduced by 15 percent unconstitutionally discriminated against foreign commerce); and *In re General Electric Co. v. Taxation and Revenue Department*, N.M. Admin. Hearings Office, Decision and Order No. 18-12, (Apr. 6, 2018) (finding that under the federal consolidated group reporting method, the “Detroit formula,” which includes in its denominator the property, payroll, and sales of the foreign subsidiary pro rata, is constitutional).

⁴⁵ See Example 3 in the Appendix.

⁴⁶ Of course, most states now either assign greater weight to the sales factor than to the property or the payroll factors, or employ a single-sales-factor regime. It would be easy enough to reconfigure the examples in the Appendix to adjust for such treatment.

tax, and the foreign dividend increases the tax on the parent corporation by \$168,000 (\$5 million × 48% apportionment factor × 7% rate). Hence the discrimination is clear.

Examples 2 and 3 represent cases that parallel the legal landscape in *Morton-Thiokol* and *du Pont*, that is, a foreign subsidiary (ForSub) that pays a dividend of \$5 million as in Example 1, but calculation of the domestic tax on a water's-edge unitary basis, with a domestic corporation (DomSub) in the group over which the taxing state has no jurisdiction and which is otherwise similarly situated to ForSub. In Example 2, we assume income and factors of DomSub as follows: income of \$10 million and property, payroll, and sales of \$120 million. The result is that inclusion of the foreign dividend, representing half the income of ForSub, increases the tax over the baseline by \$80,500, whereas inclusion of DomSub in the group decreases the tax relative to the baseline because the benefit to the taxpayer of increasing the denominators outweighs the detriment associated with including the income of DomSub in the base.

In Example 3, in which DomSub has significant income but very small property and payroll factors, its inclusion in the group increases the tax over the baseline amount by more than inclusion of the foreign dividend does (\$336,000 versus \$168,000).

At the risk of overwhelming the reader with numbers, we could of course include many other scenarios comparing the result under domestic unitary with the result when a foreign dividend or GILTI is added to the domestic apportionment base. One such example might include a domestic subsidiary and a foreign subsidiary, each with an equivalent current-year tax loss. In the domestic unitary situation, the loss will, of course, depress the tax below the baseline, perhaps dramatically. But while a foreign subsidiary with a current loss may not give rise to a GILTI inclusion, there is no such thing as a "GILTI loss" that could similarly help the group relative to the baseline tax.⁴⁷

⁴⁷ It also should be pointed out that in the context of GILTI, our assumption that only half the income of the foreign subsidiary is included in the income of the group arguably is quite conservative, and the higher the percentage of its income that constitutes GILTI, the less likely it is that the GILTI inclusion will be less detrimental to the group than the domestic unitary treatment. See Example 4 in the Appendix.

E. The Constitutional Requirement for Factor Representation in Combined Reporting States

We think that the conclusion to be drawn from these examples is that the analysis in *Morton-Thiokol* and *du Pont* was flawed insofar as it failed to take into account the taxpayer-favorable "factor dilution" effect that comes with the addition of a new company to the group.⁴⁸ Considering that this effect may outweigh the taxpayer-unfavorable effect of adding to the pre-apportionment income pie, and that it typically gives rise to an increase in tax that is less than the increase that stems from inclusion of a foreign dividend in the base without factor representation, the courts in other combined reporting states that are reviewing the constitutionality of the taxation of GILTI should not follow the lead of Kansas and Maine. Rather, they should conclude that GILTI may be in the income of a water's-edge group only if appropriate factor relief is provided.⁴⁹

The constitutional underpinning of this conclusion goes all the way back to the Supreme Court's decision in *Mobil Oil Corp. v. Commissioner of Taxes*,⁵⁰ in which the Court upheld the inclusion of dividends from unitary subsidiaries in the pre-apportionment base of income that a non-domiciliary state — Vermont — sought to tax on an apportioned basis. In one of the most oft-cited maxims in the entire state corporate tax realm, the Court observed that "the linchpin of apportionability . . . is the unitary business principle."⁵¹ While the Court was not required to determine precisely how apportionment should work in the context before it, Justice Stevens, in dissent, noted that if the theory justifying inclusion of the

⁴⁸ 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 the operations of the parent, in states other than the commercial domicile of the parent; and (2) failure to give recognition to a foreign CFC loss when the same CFC's GILTI would be included and an equivalent domestic loss would be factored into the equation.

⁴⁹ See Sheppard, *supra* note 28, at 439, 445-446. See also Hellerstein and Hellerstein, *supra* note 42, para. 9.15[4][c].

⁵⁰ 445 U.S. 425 (1980).

⁵¹ *Id.* at 439.

dividends in the base was unity as between the payer and the payee of the dividends, then the factors of the payer corporations had to be taken into account in order to treat the entire unitary enterprise consistently.⁵² As Hellerstein and Hellerstein put it:

When . . . the formula gives no recognition to the payroll, property, and sales of the entities that helped generate the apportionable income, and whose unitary relationship to the payor provides the foundation for apportionability, there ceases to be a rational relationship between the income being taxed and the activities that gave rise to the income. In short, a state should not be able to have it both ways: including the income of subsidiaries in the parent's apportionable tax base on the theory that the parent and the subsidiary are engaged in a unitary business but then apportioning such income by factors reflecting only the parent's own operations on a separate-company basis.⁵³

F. What Is Appropriate Factor Representation in the Case of GILTI?

If combined reporting states choose to tax GILTI, but concede that it is appropriate to offer factor representation both in light of constitutional considerations and as a matter of policy, what might that factor relief look like?

While there may be numerous potential factor representation formulas for GILTI, we believe that any approach should include the following principles:

- The factors that should be brought into the equation should be those of all the companies whose income contributes to GILTI, not just the factors of the first CFC in a multi-tiered foreign chain.⁵⁴ Not only is

this the appropriate answer in terms of “matching” of factors and income base, but it also mirrors the computation of allowable foreign tax credits regarding GILTI and subpart F income.⁵⁵

- Even in states that allow the section 250 deduction for GILTI, the included factors should not, in principle, be reduced by the deduction percentage. This is because it is clear in the federal law that the deduction is intended to be a de facto rate reduction for GILTI. This approach is consistent with the federal computation of foreign tax credits, which are not “discounted” to reflect the section 250 deduction.⁵⁶
- The sales factor adjustment in a factor representation approach for GILTI should include the *gross sales* of the CFCs in question, not net amounts (such as net GILTI itself), to ensure proper matching. Further, the sales factor adjustment (or other factor adjustments as required) should be combined with the domestic sales in the denominator and applied to the entire income of the group and not just to GILTI. This approach is consistent with how factor relief works in relation to domestic-source income, whether the governing formula is the traditional three-factor approach or it weighs more heavily (or includes exclusively) the sales of the taxpayer. When adding in the sales attributable to parent or subsidiary income earned in the United States, the inclusion in the sales factor is based on “gross receipts” and not “net income.”⁵⁷
- In constructing a factor relief approach, the states may look to reduce the factors to be included to the extent that the overall income of the CFCs exceeds the amount of GILTI, either because some of the income is attributed to tangible assets of the CFCs or

⁵² *Id.* at 461-462. See also *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169-171 (1983), in effect endorsing Justice Stevens's views on this point, and the state decisions cited at *supra* note 44.

⁵³ Hellerstein and Hellerstein, *supra* note 42, para. 9.15[2].

⁵⁴ See Example 4 in the Appendix.

⁵⁵ See IRC section 960(a)-(b), (d).

⁵⁶ See IRC section 250; H.R. Rep. No. 115-466, at 622 (2017). Note that the deduction is scheduled to be reduced in 2026 from 50 percent to 37.5 percent, which reinforces that Congress saw it as another way of adjusting the rate.

⁵⁷ See Model Compact articles IV.1(g) and IV.15, as revised by the MTC, July 29, 2015.

because the CFCs have subpart F income that is backed out of GILTI as a matter of course.⁵⁸ This approach would likewise be consistent with the federal computation of foreign tax credits associated with GILTI, which are “discounted” in such circumstances.⁵⁹

These guidelines are also supported by the approach taken to factor relief commonly referred to as the “Detroit formula,” so named because it was first constructed for purposes of the city of Detroit’s income tax in the late 1970s.⁶⁰ It requires the inclusion “in the denominators of the property, payroll and sales factors the property, payroll and sales of the taxpayer’s controlled foreign subsidiaries, in the same ratio that the net dividends received from such subsidiaries bears [sic] to each subsidiary’s entire net profits, but not to exceed 100% thereof.”⁶¹

Moreover, the Multistate Tax Commission has endorsed a similar concept for factor representation regarding some categories of includible foreign-source income (for example, subpart F income or income from so-called 80/20 companies) in its Model Statute for Combined Reporting. 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.”⁶²

We have included as the final example in the appendix an illustration of how the use of factor representation as discussed above might work for GILTI (Example 4).

IV. Conclusion

Federal tax reform featured a major shift in U.S. taxation of foreign earnings away from the sweeping worldwide tax regime to a quasi-territorial regime. This new approach added provisions such as GILTI, which was designed to tax a narrower scope of foreign earnings for the dual goals of raising revenue (to offset large

corporate tax cuts) and combating base erosion (by adding “low taxed” foreign income to the federal tax base).

Unfortunately, the adoption of GILTI at the state level circumvents both the goals and outcomes of the federal GILTI provision. First, the states do not conform to the federal corporate tax cuts and therefore have no reason to expand their tax base to make up for lost revenue. Second, the states do not allow GILTI to be offset by foreign tax credits, thus eliminating the primary federal provision that limits the tax base additions to low-taxed foreign-source income. This disconnect grows significantly larger in states that do not conform to the section 250 deduction; these states could levy statutory corporate tax rates on GILTI near the federal rate of 10.5 percent — an unprecedented result given the historic disparity between the federal and state rates. Finally, the state adoption of GILTI has the perverse effect of vastly expanding the state taxation of foreign earnings, in direct conflict with the federal government’s narrowing of the taxation of such income. Based on the significant differences in federal and state taxation of GILTI from both a policy and operational perspective, the states should decouple from the GILTI provision.

Moreover, from a constitutional standpoint, the taxation of GILTI by separate company filing states directly violates the U.S. Supreme Court’s decision in *Kraft*, because of the differential treatment of foreign-source and domestic-source income. And for combined reporting states, GILTI must be afforded appropriate apportionment factor representation for its taxation to pass constitutional muster.

To date, 13 states have decoupled from GILTI, and we expect more to follow. For those states that do conform to GILTI, it is important that they follow the federal model as closely as possible, including adoption of the section 250 deduction and provision of appropriate factor relief (in lieu of the allowance for foreign tax credits). Finally, on a practical note, taxpayers need regulatory guidance as soon as possible on how GILTI will work in each state for 2018 estimated payment and tax return filing purposes, as well as for purposes of providing accurate financial statement information to their shareholders.

⁵⁸ See IRC section 951A(c)(2)(A).

⁵⁹ See IRC section 960(d). See Chart 4.

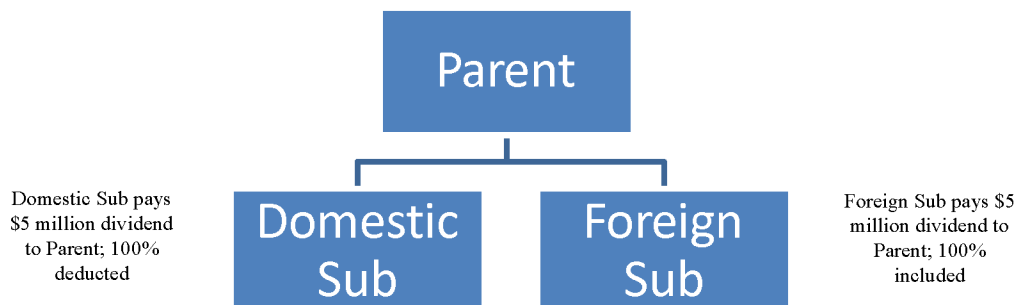
⁶⁰ See Hellerstein and Hellerstein, *supra* note 42 para. 9.15[2][a].

⁶¹ *Id.*

⁶² Multistate Tax Commission Proposed Model Statute, *supra* note 14.

Appendix

Baseline Example – Example 1 Separate Filing State



Apportionment Formula of Parent (values in millions)

	Property	Payroll	Sales	
$\frac{\text{Iowa: } 80}{\text{Total: } 100} = 80\%$	$\frac{\text{Iowa: } 60}{\text{Total: } 100} = 60\%$	$\frac{\text{Iowa: } 5}{\text{Total: } 100} = 5\%$	$\text{Overall Factor: } \frac{80 + 60 + 5}{3} = 48\%$	

Overall adjusted federal income before apportionment without dividend = \$20 million

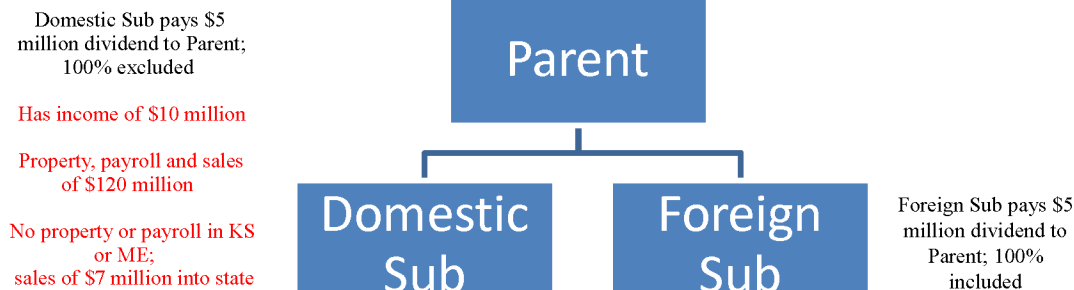
Parent Co's Iowa Income = \$20 million x 48% = \$9,600,000
 \$9,600,000 x 7% tax = **\$672,000 (baseline tax)**

How does domestic dividend impact tax?	It doesn't
Tax including dividend tax:	\$840,000
Incremental tax with foreign dividend inclusion:	\$168,000

Morton-Thiokol/Du Pont – Example 2

Water's-edge Method; Unitary State (KS/ME)

(Same facts as Example 1 unless otherwise stated)



Apportionment Formula (values in millions)

	Property	Payroll	Sales	
<u>KS/ME:</u>	<u>80</u>	<u>60</u>	<u>12</u>	Overall Factor: $\frac{36 + 27 + 5}{3}$
Total:	220	220	220	
	= 36%	= 27%	= 5%	= 23%

Overall adjusted federal income before apportionment without dividend = \$30 million

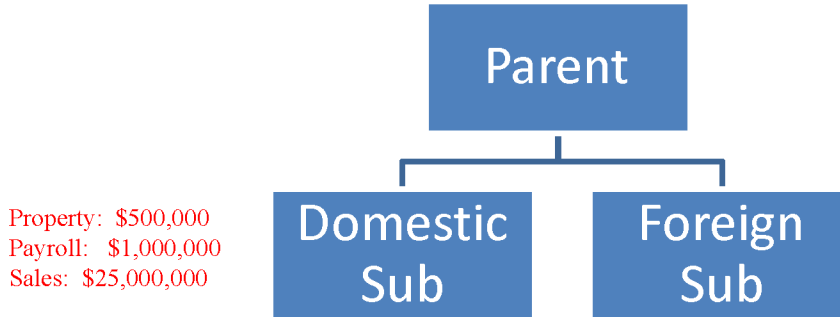
State Income = \$30 million x 23% = \$6,900,000

\$6,900,000 x 7% tax = \$483,000 → this is a reduction of \$189,000 compared to baseline

How does domestic inclusion impact tax?	(\$189,000)
How does foreign dividend impact tax?	\$80,500
Delta:	\$269,500

Morton-Thiokol/Du Pont – Example 3

Same as Example 2 except for factors of Domestic Sub



Apportionment Formula (values in millions)

Property	Payroll	Sales	Overall Factor:
$\frac{KS/ME: 80}{Total: 100.5}$	$\frac{KS/ME: 60}{Total: 101}$	$\frac{KS/ME: 7}{Total: 125}$	$\frac{80 + 59 + 6}{3}$
= 80%	= 59%	= 6%	= 48%

Overall adjusted federal income before apportionment without dividend = \$30 million

State Income = \$30 million x 48% = \$14,400,000

\$14,400,000 x 7% tax = \$1,008,000 → this is an increase of \$336,000 compared to baseline

How does domestic inclusion impact tax? \$336,000

How does foreign dividend impact tax? \$168,000

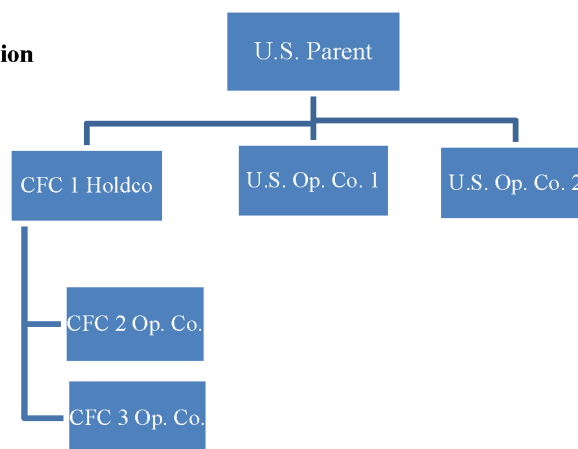
Delta: (\$168,000)

Under these facts, the company is worse off with the combination method.

GILTI Inclusion With Factor Representation – Example 4

GILTI Calculation:

Aggregate income of CFCs 1-3: \$60 million
 Less “tangible property” adjustment: \$10 million
 Less subpart F income: \$8 million
 Total: **\$42 million**
 GILTI (after Section 250 deduction): **\$21 million**



U.S. Parent, U.S. Op. Co. 1, and U.S. Op. Co. 2 operate in three states.

State 3 is a unitary state that offers factor representation.

Assume aggregate factors of CFCs 1-3 are:

Property: \$100 million
 Payroll: \$6 million
 Sales: \$240 million

Multiply each amount by 0.70 (ratio of GILTI before Sec. 250 to total CFC income) =

Property: \$70 million
 Payroll: \$4.2 million
 Sales: \$168 million

(There are no U.S. numerators)

Water's-edge income and factors of the group in State 3:

Tax without GILTI →

$$\frac{50\% + 83\% + 12\%}{3} = 48\%$$

$$48\% \times \$75 \text{ M} = \$36 \text{ M}$$

$$\$36 \text{ M} \times 7\% \text{ tax} = \$2,520,000$$

Tax with GILTI and no factor representation →

$$48\% \times \$96 \text{ M} = \$46 \text{ M}$$

$$\$46 \text{ M} \times 7\% \text{ tax} = \$3,225,600$$

Property	Payroll	Sales
<u>140</u>	<u>25</u>	<u>36</u>
280	30	300
Domestic Income of \$75 million		
GILTI of \$21 million		
Total combined income of \$96 million		

Tax with GILTI and factor representation →

$$\frac{140}{350} \quad \frac{25}{34.2} \quad \frac{36}{468}$$

$$\frac{40\% + 73\% + 8\%}{3} = 40\%$$

$$40\% \times \$96 \text{ M} = \$38,400,000$$

$$\$38.4 \text{ M} \times 7\% \text{ tax} = \$2,688,000$$

The addition of GILTI with factor representation increases the tax by \$168,000.
The addition of GILTI with no factor representation increases the tax by \$705,600.
Factor representation reduces GILTI detriment by \$537,600.



*You can scour the globe
for tax expertise.
Or find it all in one place.*



To keep their expertise up to date each day, tax professionals look to *Worldwide Tax Daily*. It's the only daily service for timely international tax news and developments from more than 180 countries – with news stories and updates by more than 200 correspondents and practitioners.

To learn more, please visit us at taxnotes.com

taxnotes[®]

Worldwide Tax Daily