Eureka Not! California CIT Reform Is Ill-Conceived, Punitive, and Mistimed

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In this article, Frieden and Kenney examine the major provisions of California's A.B. 71, proposed legislation that significantly expands the state's taxation of foreign-source income.

Introduction

On December 7, 2020, A.B. 71 was introduced in the California State Assembly. The measure would establish a "Bring California Home" fund derived from corporate tax increases to pay for a statewide homelessness solutions program. The bill passed the Assembly Revenue and Tax Committee April 19 and the Assembly Housing and Community Development Committee April 29. The bill has generated significant political momentum and is now under consideration by the Assembly's Appropriations Committee.[1] Despite the well-intentioned purpose of the bill, which is laudable, A.B. 71 contains one of the most ill-advised, mistimed, and inequitable corporate tax proposals ever seriously considered in California.

In one gigantic step backward for the state, this proposed legislation would:

- retroactively increase California taxes on unrepatriated foreign-source income earned over the 30-year period (1986 to 2017) by 60 percent and provide no constitutionally required foreign factor representation when apportioning such income;
- add a new tax on 50 percent of foreign-source income categorized as global intangible low-taxed income and once again provide no foreign factor representation when apportioning such income;
- base the two new taxes on a grossly erroneous assertion that all such foreign-source income is really "displaced domestic income;"
- implement both new taxes using methods that likely violate the U.S. Constitution in not one but at least four different ways and may tie up the statute in litigation for years;
- blatantly coerce California taxpayers to change their method of filing corporate income taxes from a water's-edge combined reporting method to a controversial mandatory worldwide combined reporting method abandoned by California and all other states decades ago; and
- impose these new taxes on top of a state income tax system with the highest collective tax rates on corporate income and corporate distributions of all but one of the states in the nation.

If that were not enough, the legislation would constitute perhaps the largest state corporate tax increase ever that specifically targets the U.S.

[1] As a tax increase, A.B. 71 would require a supermajority vote (two-thirds) of both the California State Assembly and Senate.

multinationals that are foundational to California's economy. A.B. 71 is estimated to raise $2.8 billion in its first four years.[2] Every tax dollar raised comes from U.S. multinationals; no new taxes under the bill would be paid by foreign multinationals doing business in California but based in China, Germany, Japan, India, the United Kingdom, or any other nation. Despite this fact, there has been no acknowledgment that imposing a massive tax increase solely on U.S. multinationals might create a significant competitive disadvantage for U.S. businesses in relation to foreign-based multinationals that do not face similar tax burdens imposed by their home countries.

Finally, the proposed California legislation is disastrously mistimed. President Biden has proposed sweeping corporate tax reform legislation, including a significant increase in the tax rate and tax base of U.S. multinationals' foreign-source income. The ambitious aim of the Biden plan is to address profit shifting and to reimpose a "residence-based" tax on the global income of U.S. multinationals. The enactment of the foreign-source income provisions of Biden's corporate tax plan, in whole or substantial part, would immediately render A.B. 71 outdated, redundant, and punitive. The day after enactment of Biden's plan, the debate would instantly change from whether U.S. multinationals are paying enough taxes to whether they are paying too much in taxes, particularly in relation to their foreign competitors. Astonishingly, the Committee on Revenue and Taxation's report makes no mention of the president's Made in America Tax Plan and its potentially enormous impact, if enacted, on A.B. 71, even though the Biden plan was released several weeks before the committee hearing.

This article examines the major provisions of A.B. 71. We start by discussing California's historical approach to taxing foreign-source income; analyze the primary proposed legislative changes to the corporate income tax rules; and finally highlight how out of step A.B. 71 is with the approach used by the federal government and virtually every other major U.S. state to tax foreign-source income. Along the way, we debunk the various justifications made by proponents of the legislation. Finally, we explain why, in addition to the ill-conceived design and anti-U.S. multinational impact of A.B. 71 on a stand-alone basis, the proposed legislation is likely to be rendered obsolete and harmfully counterproductive if the foreign tax provisions of the Biden administration's federal tax reform are fully or partially enacted.

The Proposed Changes to California's Taxation Of Foreign-Source Income

California provides two methods for corporations to file corporate income taxes under what is called the state's "corporation franchise tax." First, as a default method, California requires corporate groups to file their corporation franchise or income tax returns using a worldwide combined reporting method that includes all domestic and foreign income and apportionment factors in the calculation of corporate income subject to tax in the state.[3]

Second, California provides an election for taxpayers to file corporate income tax returns based on a water's-edge combined reporting method, which includes all the domestic income and apportionment factors in the calculation of corporate income subject to tax.[4] Since 1986 taxpayers that make the water's-edge election are required to include in the tax base, in addition to domestic source income, 25 percent of foreign-source income, but only on a deferred basis after the foreign earnings are "repatriated" and distributed to U.S. shareholders as dividends.[5] For California apportionment purposes, net taxable dividends are included in the denominator of the taxpayer's apportionment factors.[6]

[2]The Franchise Tax Board estimates that A.B. 71 will increase revenue to the general fund by $310 million in fiscal 2021-2022, $950 million in fiscal 2022-2023, $950 million in fiscal 2023-2024, and $600 million in fiscal 2024-2025.

[3]Cal. Rev. & Tax. Code section 25101; *see also* California FTB Informational Publication No. 1061 (Dec. 1, 2015).

[4]Cal. Rev. & Tax. Code section 25110.

[5]*See* Cal. Rev. & Tax. Code section 24411. Section 2441 allows taxpayers that have elected to compute their income on a water's-edge basis a deduction for specific qualifying dividends by providing a 75 percent deduction for qualifying foreign dividends received.

[6]Cal. Code Regs. section 25110(d)(2)(E)2. The two reporting methods authorized by California are commonly used in many states. No state requires all taxpayers to file a mandatory worldwide combined return without providing the option of a water's-edge election.

A.B. 71 would drastically expand the California inclusion of foreign-source income in the water's-edge combined filer's tax base.[7] First, on a one-time basis, the proposed legislation requires a taxpayer that makes a water's-edge election to include 40 percent of its undistributed foreign dividend income from 1986 to 2017 in the tax base.[8] At the same time, the legislation prohibits the taxpayer from including in its apportionment factor denominator any of the foreign sales that contributed to the generation of the repatriated income.

Second, A.B. 71 requires a taxpayer that makes a water's-edge election to include on a current basis, 50 percent of foreign-source income categorized as GILTI for federal tax purposes. Once again, the bill expressly prohibits the taxpayer from including in its apportionment factor any of the foreign sales that contributed to the generation of the GILTI earnings.

These provisions would apply to tax years beginning January 1, 2022. The bill allows a taxpayer, for calendar year 2022 only, the opportunity to revoke its water's-edge election and choose to file under a worldwide combined reporting method. If a taxpayer files on a worldwide basis, the deemed repatriation of 30 years of corporate dividend income is not included in the tax base. The bill also contains a provision limiting the use of business credits to offset the additional tax liability.

Critique of A.B. 71 Treatment of Deemed Repatriated Dividends

Supporters of A.B. 71 may be asking: What is wrong with California's proposed tax on 40 percent of deemed repatriated income? After all, California has taxed a portion of foreign dividends since 1986. Further, the federal government, as part of the Tax Cuts and Jobs Act in 2017, also included 30 years of "deemed repatriated" dividends in the federal tax base, as did a modest number of other states that had previously taxed a portion of foreign dividends.[9]

But that is where the similarities end. If A.B. 71 is enacted, California would become the only state to retroactively increase the share of foreign dividends subject to tax from the historically taxable share (when repatriated). All other states simply sped up the taxation (through deemed repatriation) of the share of foreign dividends already included in the state's tax base.[10]

In a dubious exercise of state taxing power and overreach, four years after the enactment of the TCJA's section 965 deemed repatriation provision, A.B. 71 would increase the share of foreign dividends taxed in the state from 25 percent to 40 percent — an astounding 60 percent retroactive tax increase that applies to all foreign-source income earned (but not repatriated to U.S. shareholders) beginning in 1986. Taxpayers, particularly large taxpayers, crave certainty and predictability. Consider that each year for more than 30 years, California has told taxpayers that only 25 percent of foreign dividends were taxable in California, on a deferred basis, in the year of the actual distribution. Now, 30 years later, California is proposing to (1) tax 40 percent of deferred foreign dividends instead of 25 percent and (2) deem those earnings as repatriated dividends and therefore taxable immediately instead of over time.[11]

But that's not the end of California's proposal. A.B. 71 also provides that when this income is deemed repatriated, no foreign factor representation is allowed. Apportionment factor representation of income included in the tax base is a fundamental principle of state tax law, as required

[7]Cal. Rev. & Tax. Code section 25110.1.

[8]A.B. 71, section 3, adding section 25110.1 to the Cal. Rev. & Tax. Code to read "beginning January 1, 2022, a taxpayer that makes a water's edge election shall take into account 40 percent of the repatriation income, but not the apportionment factors, of its affiliated corporations."

[9]26 U.S.C. section 965 requires U.S. shareholders (as defined under section 951(b)) to pay a transition tax on the untaxed foreign earnings of specified foreign corporations as if those earnings had been repatriated to the United States. *See also* Joseph X. Donovan et al., "State Taxation of GILTI: Policy and Constitutional Ramifications," *State Tax Notes*, Oct. 22, 2018, p. 315.

[10]For example, Massachusetts and Tennessee both tax 5 percent of foreign dividends and 5 percent of IRC section 965 income. Utah taxed 50 percent of foreign dividends and 50 percent of IRC section 965 income. *See* Karl A. Frieden and Donovan, "Where in the World Is Factor Representation for Foreign-Source Income?" *State Tax Notes*, Apr. 15, 2019, p. 199.

[11]The impact of this change is significant. Over the years, many large multinational taxpayers held on to a large share of the foreign earnings to avoid the federal (and state) "deferred" taxes on distributed foreign dividends. Many of them operating in California are still likely doing so. *See* Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits Under the Tax Cuts and Jobs Act," Tax Foundation Fiscal Fact 586, at 3 (May 2018).

by the U.S. Constitution's commerce clause. Fair apportionment of multijurisdictional income requires that when "income" is included in the state tax base, the "factors" that created that income (such as property, payroll, and sales, depending on the state's apportionment formula) are also included in the apportionment formula used to calculate the share of income taxable in the state.[12] Historically, California has followed this principle by allowing the inclusion of the amount of net taxable dividends in the denominator of the sales factor for the 25 percent of foreign dividends taxable for water's-edge filers.[13] Once again, however, 30 years after California first provided for at least some foreign factor representation when taxing foreign dividends, the state is retroactively changing well-established rules and claiming that the taxpayer is not entitled to any foreign factor representation when any foreign dividends — even a larger share — are included in the corporate income tax base.

Interestingly, A.B. 71 also offers taxpayers the option to choose a novel apportionment factor alternative. The legislation states that if a taxpayer does not like the fact that no foreign factor representation is allowed in apportioning the deemed repatriated dividends, it can elect to use a "special" 14 percent apportionment factor just for this income. Presumably, this percentage is derived from the approximate share of California gross domestic product over U.S. GDP. But this provision is of no value to the large number of multinational businesses, particularly those out-of-state companies with California apportionment factors of less than 14 percent on their domestic income. For those companies, the 14 percent election would increase the share of foreign income subject to tax in California. It is only of value to businesses that have an apportionment share in California over the 30-year period that exceeds 14 percent. This is almost by definition California-headquartered companies that historically may have had a higher ratio of apportionment factors in California. Thus, this alternative formula, far from providing a safe harbor, favors in-state businesses over out-of-state businesses; as such, it is not only unfair but likely unconstitutional as well.

To put A.B. 71 and California's historical taxation of foreign dividends in perspective, it is important to recognize that the taxation of any repatriated foreign dividends is clearly an outlier position among the largest states in the country. Of the 20 most populated states — which make up 76 percent of the nation's population — only three other states tax any level of deemed repatriated dividends (Massachusetts, New Jersey, and Tennessee), and all three tax only a de minimis 5 percent of the dividends (see Table 1). Thus, not only is A.B. 71's overreach a departure from the approach of other states that previously taxed foreign dividends, but the taxation of any foreign dividends at all is an outlier position among the most populated states.

Similarly, in comparison with the other less populated states that conformed to the TCJA's section 965 deemed repatriated dividends provision, if A.B. 71 is enacted, California would be the only state that taxes more than a de minimis amount of foreign dividends and expressly prohibits taxpayers from including the foreign factors that contributed to the production of the repatriated foreign earnings in the state's apportionment formula. Of the dozen or so mostly less populated states that tax foreign dividends, all either allow some portion of foreign sales in the denominator or have no clear guidance preventing a taxpayer from doing so.[14] Thus, while A.B. 71's sharp departure from apportionment norms and constitutional requirements is inconsistent with other state approaches to taxing repatriated dividends, it is consistent with the proposed legislation's unprecedented and inequitable effort to retroactively change the rules of the game.

[12] *See* Frieden and Donovan, *supra* note 10. Note that California has mandated apportionment using a single sales factor since 2013. For the periods before 2013, California businesses were required to use a three-factor formula to apportion income consisting of property, payroll, and sales. Single-factor apportionment could be elected by most taxpayers from 2011 through 2012.

[13] The sales factor is a fraction with the numerator consisting of California sales and the denominator consisting of total sales (Cal. Rev. & Tax. Code section 25134). Sales include all gross receipts derived from business activities in the regular course of a taxpayer's trade or business (Cal. Code Regs. section 25134). Sales are defined as "all gross receipts" not allocated under sections 25123 to 25127 (Cal. Rev. & Tax. Code section 25120(f)(1)). The definition of gross receipts includes gross amounts realized on the use of property or capital (including dividends) that produces business income except for some enumerated exclusions (Cal. Rev. & Tax. Code section 25120(f)(2). Exclusions from "gross receipts" contained in Cal. Rev. & Tax. Code section 25120(f) are not applicable to dividends producing business income. The FTB relies on Situation 2 in FTB Legal Ruling 2006-01 to support the net dividend amount in the sales factor.

[14] *See* Frieden and Donovan, *supra* note 10, at 203.

Table 1. Current State Income Tax Treatment of IRC Section 965 Income in Most Populous States

State	Tax on IRC Section 965 Income	Apportionment Factor Treatment	Population*
California	8.84% on 40% IRC section 965 (Proposed in A.B. 71)	No factor representation	39,538,223
Texas	**	N/A	29,145,505
Florida	None	N/A	21,538,187
New York	None	N/A	20,201,249
Pennsylvania	None	N/A	13,002,700
Illinois	None	N/A	12,812,508
Ohio	**	N/A	11,799,448
Georgia	None	N/A	10,711,908
North Carolina	None	N/A	10,439,388
Michigan	None	N/A	10,077,331
New Jersey	11.5% on 5% of IRC section 965	Net IRC section 965 in apportionment factor denominator	9,288,994
Virginia	None	N/A	8,631,393
Washington	**	N/A	7,705,281
Arizona	None	N/A	7,151,502
Massachusetts	8% on 5% of IRC section 965	No factor representation	7,029,917
Tennessee	6.5% on 5% of IRC section 965	No factor representation	6,910,840
Indiana	None	N/A	6,785,528
Maryland	None	N/A	6,177,224
Missouri	None	N/A	6,154,913
Wisconsin	None	N/A	5,893,718

*William H. Frey, "Census 2020: First Results Show Near Historically Low Population Growth and a First-Ever Congressional Seat Loss for California," Brookings Institution (Apr. 26, 2021). This table represents the top 20 states by population and reflects 75.9 percent of total population of the United States.

** Texas, Ohio, and Washington do not impose a corporate income tax. Each of these states impose a gross receipts tax or modified gross receipts tax at rates that are not comparable to income tax rates.

Source: Council On State Taxation.

A.B. 71 not only diverges from state norms regarding section 965 deemed repatriation but also from the federal government's implementation of the provision. First, under the TCJA's rules, the federal government did not expand, but reduced, the share (or impact) of foreign dividends subject to tax under the deemed repatriation provision. While the federal government historically taxed 100 percent of foreign dividends (on a deferred basis), under the TCJA rules, the deemed repatriated dividends were taxed at only 20 to 40 percent of the federal corporate tax rate, giving taxpayers a substantial discount.[15] Second, under the deemed repatriation provision, the federal government allows

[15] 26 U.S.C. section 965.

taxpayers to first reduce any tax on foreign earnings by the amount of foreign taxes paid on such earnings in prior years. Foreign tax credits are the federal equivalent of apportionment factors for ensuring that double taxation is avoided and that foreign earnings are treated similarly to domestic earnings.

The federal government did not abandon its historical method for applying FTCs as California proposes to do with its apportionment rules. Finally, the TCJA adopted the deemed repatriation process because the federal government was abandoning the taxation of foreign dividends entirely (on a going-forward basis) and switching to a new system of taxing a portion of foreign earnings (GILTI) instead. California, on the other hand, is continuing to tax both a portion of foreign dividends and GILTI on a going-forward basis.

If A.B. 71 is enacted, its requirement that taxpayers increase by 60 percent the historical share of foreign dividends included in the state corporate tax base will clearly face a constitutional challenge under the due process clause of the U.S. Constitution. Retroactive tax law changes are not permitted beyond a reasonably short duration, and a 30-year retroactive tax law change clearly fails this test.[16] The legislation will also face a challenge under the foreign commerce clause for treating income from foreign affiliates (no foreign factor representation) differently from income from domestic affiliates (full domestic factor representation). Finally, the provision of a 14 percent factor option is likely to be challenged as well under the commerce clause prohibition against favoring in-state businesses over out-of-state businesses.

The flaws in A.B. 71's approach to taxing deemed repatriated income are not limited to the constitutional infirmities. The bill's method is also filled with glaring unfairness and impracticalities. A key element of good tax administration is transparency. To change the rules of the game — particularly regarding key elements, such as the corporate tax base or tax rates — is an egregious act that will undermine corporate taxpayers' confidence in California state government for years to come.[17]

Perhaps in recognition of the constitutional infirmities of the tax base increase and denial of foreign factor representation in connection with deemed repatriated dividends, California presents an "out." A.B. 71 offers taxpayers a one-time election to switch to the worldwide combination filing method. If a taxpayer does so, the retroactive tax on foreign dividends will not apply.

At first glance, this provision appears to be a magnanimous gesture, allowing taxpayers to avoid the onerous and unconstitutional new provisions for taxing previously undistributed foreign dividends. But in reality, it is a coercive measure to force companies to adopt de facto "mandatory" worldwide combined reporting, which one suspects is the goal of the provision in the first place. This deal is offered only to companies that elect the worldwide combination filing method. It is self-evident that the availability of a true election or choice between

[16] *See United States v. Carlton*, 512 U.S. 26 (1994). *See also* Brief Amicus Curiae of the Council On State Taxation in support of the Petitioner (Oct. 16, 2016) in *Dot Foods Inc. v. Department of Revenue of the State of Washington*, 215 P.3d 185, *cert. denied* (2017). The sponsors of A.B. 71 claim the change in the share of repatriated dividends subject to tax is not a "retroactive" change. "This tax is not retroactive, as it only applies to income repatriated in future tax years." Assembly Committee on Housing and Community Development, A.B. 71 Bill Analysis, at 13 (Apr. 29, 2021). This argument completely misses the point. Foreign dividends, when repatriated, represent untaxed foreign earnings from prior years. The taxation of the earnings is deferred until the dividends are repatriated or deemed repatriated. But the economic activity underlying the dividends occurred year by year over the 30-year period, at a time when California law stated that only 25 percent of the dividends were subject to tax. The fact that the state, following the federal government's treatment of foreign earnings, chooses to collect the tax on a deferred basis when repatriated or deemed repatriated affects the timing of the tax, not its imposition. To wait 30-plus years to inform taxpayers that the share of foreign income earned in prior years that is subject to tax is now increased by 60 percent qualifies as a retroactive tax and a grossly unfair and unconstitutional one at that. This is different from capital gains on the sales of assets. In that case, the gains are unrealized until the time of sale, at which time the tax rates may have changed. In the case of dividends, the amount of earned income is fixed; the only issue is the timing of the tax due.

[17] As an example of the complexity and unfairness of A.B. 71, under section 25110.1(e), a credit for taxes paid to California on repatriated income can be created only to the extent the dividend paid by the foreign corporation was included in income and therefore subject to tax. This will typically apply when a dividend is subject to the section 24411 (75 percent) dividends received deduction. If it is subject to the dividends received deduction, 25 percent of the dividend will be taxed by California. However, if a dividend is eliminated as intercompany, then no credit can be created. This can lead to double taxation for CFCs that have been partially included based on subpart F income over current-year earnings and profits (for years before 2018). Consider, also, that to avoid duplicate taxation on income that may have already been taxed by California under the existing foreign dividend provisions, A.B. 71 would require California taxpayers to compute taxes paid to California on repatriated income going back to the inception of the foreign dividend deduction (over 30 years), imposing a significant compliance burden on the taxpayers.

filing methods should not depend on heavily penalizing companies that choose to remain water's-edge filers. Otherwise, the statute effectively becomes a mandate for worldwide combination reporting, which is not the statutory scheme of California or any state.[18]

Critique of A.B. 71 Adoption of 50 Percent of GILTI

A.B. 71's second proposed expansion of the state's taxation of foreign-source income — the adoption of a new provision to tax 50 percent of GILTI — is equally troubling. Again, at first glance, the bill's supporters may ask: What is the matter with taxing 50 percent of GILTI? Isn't this the same provision the federal government adopted as part of the TCJA? And don't a minority of other states also tax portions of GILTI, ranging from 5 to 50 percent?

The enactment of GILTI was a key component of the federal government's shift in the TCJA from a worldwide residence-based system of taxing all foreign-source income earned by U.S. multinationals on a deferred basis (foreign dividends taxed when repatriated), to a quasi-territorial system that taxes a smaller share of foreign-source income on a current income basis.

The new federal GILTI provision has two primary purposes. First, it was a response to concerns that a shift away from worldwide taxation of U.S. businesses would encourage U.S. multinationals to expand foreign operations to take advantage of favorable low-tax jurisdictions in other countries. GILTI, in combination with the foreign-derived intangible income provision, was developed to encourage U.S. companies to keep production and intangible assets in the United States. The formula for GILTI starts with the total foreign income of the foreign subsidiaries of U.S. multinationals. From that income, a deduction is allowed for what is deemed a "normal" (10 percent) return on a taxpayer's tangible property located outside the United States as measured by the property's depreciated value (called qualified business asset investment). A tax rate of 10.5 percent, half the new corporate income tax rate of 21 percent, is then applied to GILTI (by means of a new 50 percent IRC section 250 deduction). Finally, an 80 percent FTC is allowed to reflect taxes already paid on that same income in other countries.

The net result of the GILTI formula is the imposition of a minimum tax of 13.125 percent on current-year foreign earnings (less QBAI) of foreign subsidiaries. GILTI was aimed not just at curbing profit shifting to no- or low-tax jurisdictions but also at eliminating tax advantages encouraging U.S. multinationals to locate corporate production and other operations in low-tax countries below the minimum tax rate (30 countries, including Ireland, levy corporate tax rates ranging between 5 and 15 percent) and reducing the tax advantages in other higher-tax countries.[19]

The second purpose of the new GILTI provision (along with the section 965 deemed repatriated income provision) is to raise tax revenue to help offset large revenue losses from reduction of the federal corporate tax rate from 35 percent to 21 percent in the TCJA. Together, GILTI and section 965 repatriated income are estimated by the Joint Committee on Taxation to bring in about $500 billion over 10 years, partially offsetting the cost of the corporate tax rate cut.[20]

A further indication of the revenue-raising objective of GILTI is that the IRC section 250 deduction is scheduled to decrease from 50 percent to 37.5 percent in 2026. This change will increase the effective minimum tax rate on GILTI to 16.40 percent. The timing of this change is not a coincidence. 2026 is the year when Congress

[18] On the abandonment of mandatory worldwide combined reporting at the state level, see Frieden and Ferdinand Hogroian, "State Tax Haven Legislation: A Misguided Approach to a Global Issue," State Tax Research Institute, at 31 (Feb. 2016).

[19] *See* Elke Asen, "Corporate Tax Rates Around the World, 2020," Tax Foundation (Dec. 9, 2020). GILTI operates in conjunction with the deduction for foreign-derived intangible income, a mechanism in the TCJA that allows a domestic corporation a 37.5 percent deduction of the excess of the corporation's income from export sales over a fixed return on tangible depreciable assets. The FDII deduction, in conjunction with GILTI, was designed to encourage U.S. multinational corporations to increase U.S. investment and provide an incentive for export-related domestic production.

[20] *See* Donovan et al., *supra* note 9, at 33, citing Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17 (Dec. 18, 2017).

needs more money to satisfy the requirement under the budget reconciliation rules to make the TCJA revenue neutral within a 10-year period.[21]

That is how GILTI works at the federal level. At the state level, however, the mechanics and impact of GILTI are much different. First, states do not conform to the FTC. As a result, all GILTI, whether from low-tax or high-tax countries, is subject to state corporate income tax. For example, if three different U.S. multinationals incur $20 million of GILTI in three different countries, and one is taxed at 0 percent, one at 10 percent, and one at 20 percent, it makes no difference for state tax purposes. The state tax base will include $20 million of GILTI in all three scenarios. 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 ensures that the GILTI tax base is typically much broader for state tax purposes than for federal tax purposes.

Second, when a state adopts GILTI, it does not also automatically conform to the federal corporate income tax rate cut. Therefore, whereas corporate taxpayers under the TCJA are granted a net federal corporate income tax reduction of about 10 percent, even after taking into account the base-broadening impact of GILTI and section 965 repatriated income (and other provisions), at the state level, GILTI can result in a significant tax increase.[22] Indeed, since most states before the TCJA did not tax any foreign income, or taxed only a modest share of foreign dividends (when distributed), conformity to the TCJA's foreign tax base changes (including taxing 50 percent of GILTI and section 965 deemed repatriated income) results in taxing far more foreign-source income — on a current basis, not a deferred basis — than states had done previously. Moreover, under international tax laws and treaties, the United States is not allowed to tax the worldwide income of foreign-based multinationals. As a result, by definition, any increase in federal (and state) taxes on foreign-source income is solely imposed on U.S. multinationals.

The historical difference between federal and state inclusion of foreign-source income in the corporate tax base (more limited for the states) and the differential outcome of the inclusion of GILTI in federal and state tax bases (more expansive for the states), along with other local factors, have resulted in a majority of the most populated states not conforming to GILTI. Of the 20 most populated states, only two — Maryland and New Jersey — have conformed fully to the federal provision and tax 50 percent of GILTI. Three others — Massachusetts, New York, and Tennessee — include 5 percent of GILTI in the corporate income tax base but typically as a proxy for the disallowance of expense deductions relating to GILTI income that is not otherwise in the tax base. Thus, if A.B. 71 is enacted, and California begins taxing 50 percent of GILTI, it will be an outlier among the most populated states, becoming only the third of the 20 most populated states to tax more than a de minimis amount of GILTI (see Table 2).

As with the section 965 repatriated income provision, A.B. 71 proposes to bring 50 percent of GILTI into the state tax base beginning in 2022 but will prohibit multinational taxpayers from including in the state's apportionment formula any of the foreign sales that contributed to the production of the GILTI amounts. This raises the same constitutional infirmities as discussed above with the lack of foreign factor representation in connection with the deemed repatriated income. This is not only discriminatory against businesses with large foreign operations, but also arbitrary and unfair. The higher a U.S. multinational's share of foreign sales to domestic sales, the more distorted the apportionment of the combined domestic and foreign income becomes. Once again, if A.B. 71's apportionment rules become law, California would become an outlier as the only state that taxes more than a de minimis amount of GILTI and fails to allow some foreign factor representation in the apportionment formula (Table 2).

[21] *See* Congressional Budget Office, "Increase Individual Income Tax Rates" (Dec. 13, 2018). In 2026 the number of temporary tax reductions to the individual income tax also expire, and six of the seven statutory rates in the range of 12 to 37 percent are raised back to the range of 15 to 39.6 percent. *Id.*

[22] *See* Donovan et al., *supra* note 9, at 33.

Table 2. Current State Income Tax Treatment of GILTI in Most Populous States

State	Tax on GILTI	Apportionment Factor Treatment
California	8.84% on 50% GILTI (Proposed in A.B. 71)	No factor representation
Texas	**	N/A
Florida	None	N/A
New York*	7.25% on 5% of GILTI	Net GILTI in apportionment factor denominator
Pennsylvania	None	N/A
Illinois	None	N/A
Ohio	**	N/A
Georgia	None	N/A
North Carolina	None	N/A
Michigan	None	N/A
New Jersey	11.5% on 50% of GILTI	Net GILTI in apportionment factor denominator
Virginia	None	N/A
Washington	**	N/A
Arizona	None	N/A
Massachusetts	8% on 5% of GILTI	No factor representation
Tennessee	6.5% on 5% of GILTI	No factor representation
Indiana	None	N/A
Maryland	8.25% on 50% of GILTI	Other representation
Missouri	None	N/A
Wisconsin	None	N/A

* State only. New York City taxes 50 percent of GILTI at 8.85 percent.

** Texas, Ohio, and Washington do not impose a corporate income tax. Each of these states impose a gross receipts tax or modified gross receipts tax at rates that are not comparable to income tax rates.

Source: Council On State Taxation.

The prohibition of using apportionment factors that account for the generation of GILTI in foreign countries is not only out of sync with how other states allocate income from GILTI, but it also diverges from how California has historically apportioned other types of foreign-source income included in the corporate income tax base. For example, with subpart F income (a limited category of passive income taxed federally and by California), the state allows full foreign factor representation.[23] For foreign income included in the tax base in connection with a worldwide combined reporting filer, the state also allows full foreign factor representation.[24] Finally, for water's-edge filers, in connection with the 25 percent of foreign dividends subject to tax when distributed, the state allows inclusion of the net dividend amount in the sales factor.[25] Nonetheless, after decades of allowing full or partial foreign factor representation when taxing foreign-source income, in A.B. 71, California would switch to the blatantly unfair and unconstitutional method of bringing additional foreign income into the tax base but denying the taxpayer any factor representation to balance the tax base expansion with an equivalent apportionment factor adjustment.

Proponents' Justifications for A.B. 71's Taxation Of Section 965 Repatriated Income and GILTI

Thus far, we have analyzed the provisions in A.B. 71 that propose to tax section 965 deemed repatriated income and GILTI and how California's method for doing so compares unfavorably both with other states and with the federal government's adoption of similar measures. We now turn to the various rationales offered by proponents of A.B. 71 for expanding the water's-edge combined filers tax base to include significantly more foreign-source income, without allowing for foreign factor representation. The three primary justifications offered by the proponents of A.B. 71 are:

- the proposed corporate tax reform simply updates California's corporate income tax law to conform to federal tax policy changes;
- businesses do not pay their fair share of taxes, and the corporate tax increases are warranted; and
- the two new taxes on foreign-source income — GILTI and section 965 deemed repatriated income — represent displaced domestic income that should be considered part of the domestic tax base and not the foreign tax base.

Justification 1: The Proposed California Legislation Is Simply Conforming to Federal Tax Policy

A first justification is that A.B. 71 is really no big deal — simply a measure that conforms California corporate tax law to federal tax law (and that of other states). Based on this reasoning, the proposed legislation is nothing out of the ordinary, more akin to updating California's statutes to reflect changes adopted by the federal government and other states.

Several statements made in the A.B. 71 hearings and in other writings harp on this theme of "mere conformity." During the Revenue and Taxation Committee hearing, California State Assembly member Bill Quirk said, "Look, this really isn't a tax increase. This is trying to do the same thing the federal government did, which is take monies that shouldn't be hidden abroad and make sure they are allocated where they were earned, which is in California."[26]

Similarly, in the same hearing, Darien Shanske, a law professor and one of the leading proponents of the conceptual basis of A.B. 71, said, "So all this bill does is say that the Tax Cuts and Jobs Act recognized that the old regime, including subpart F, was not working very well in terms of combatting income stripping, created a

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[23] Cal. Rev. & Tax. Code section 25110(a)(2)(A)(ii) provides how to calculate the CFC inclusion amount for income and apportionment factors by stating:

> The income and apportionment factors of that corporation that is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, to the extent determined by multiplying the income and apportionment factors of that corporation without application of this subparagraph by a fraction not to exceed one, the numerator of which is the "subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable year.

See also Reg. 25110(d)(2)(E)2.

[24] Cal. Code Regs. section 25110(d)(2)(E)2.

[25] *See supra* note 13.

[26] *See* California Assembly Revenue and Taxation Committee hearing (Apr. 19, 2021). Quoted text can be heard at approximately 1:30.

new category of income deemed suspicious and likely shifted out of the domestic tax base, and the federal government brings that income back into the domestic tax base, and so all California would do would be conform and do the very same thing."[27]

Finally, the sponsors of A.B. 71 are quoted in the Assembly Committee on Housing and Community Development report: "This tax-avoidance safeguard [GILTI] appropriately taxes California income and is a commonsense tax conformity measure that brings our tax code in line with other states and the federal Internal Revenue Code."[28]

The discussion in the earlier sections of this article makes it clear that California may be conforming mechanically to federal and other state provisions for taxing foreign-source income, but substantively, the state's approach is better characterized as incongruous. To that end, a brief review of the design flaws and policy manipulations in the California approach to taxing deemed repatriated earnings and GILTI puts to rest any notion that A.B. 71 is simply conforming to other federal and state precedents.

First, A.B. 71's method for taxing section 965 deemed repatriated earnings markedly differs from other similar state proposals:

- Before A.B. 71, California is already an outlier, the only one of the 20 most populated states that taxes more than a de minimis level of foreign dividends.
- If A.B. 71 is enacted, California would be the only one of all 50 states to retroactively increase (by 60 percent) the share of foreign dividends subject to tax from the historically taxable share of such foreign dividend income in the state.
- With A.B. 71, California would become the only state to tax more than a de minimis amount of foreign dividends and deny corporate taxpayers any foreign factor representation in apportioning such income.

Second, A.B. 71's provision for taxing section 965 deemed repatriated earnings is drastically different from the federal approach:

- California would increase by 60 percent the level of deemed repatriated earnings subject to tax above the historically taxable share. The federal government actually reduced the tax rate on deemed repatriated earnings by 60 to 80 percent of the historical federal tax rate.
- California would deny taxpayers the right to use any foreign factor representation to apportion the deemed repatriated earnings. The federal government allows FTCs to offset foreign dividends already subject to tax in foreign countries in prior years.

Third, A.B. 71's proposed rules for taxing GILTI are significantly different from other states:

- For starters, under A.B. 71, California would begin to tax 50 percent of GILTI, a clear outlier position as only two other states (Maryland and New Jersey) and one other city (New York City) among the 20 most populous states tax more than a de minimis amount of GILTI.
- With A.B. 71, California would become the only state that taxes more than a de minimis amount of GILTI that denies corporate taxpayers any foreign factor representation in apportioning such income.
- With A.B. 71, California even diverges from its own historical approach of allowing full or significant foreign factor representation for foreign-source income subject to state tax.

Finally, A.B. 71's proposed rules for taxing GILTI are radically different from the federal approach:

- With A.B. 71, California would include all GILTI in the state tax base without making any allowances for foreign-source income already taxed in foreign countries. The federal government allows an 80 percent FTC to limit the application of GILTI to low-tax jurisdictions.
- With A.B. 71, California would decouple from something called the high-tax exception, which is a safe harbor developed by federal regulation that allows taxpayers

[27] *Id.* at 1:07.

[28] *See* Assembly Committee on Housing and Community Development's A.B. 71 Bill Analysis, *supra* note 16, at 13.

to elect to exclude any GILTI earned in a country with over an 18.9 percent tax rate. In their zeal to tax all or most foreign-source income and ignore which portion of it is low-taxed and which portion is high-taxed, the drafters of A.B. 71 apparently have no boundaries.[29]

- With A.B. 71, the inclusion of GILTI in the corporate tax base would constitute a large corporate tax increase. The federal government coupled the introduction of GILTI and other foreign tax provisions with a large corporate tax cut, resulting in an overall reduction in the corporate tax rate.

A review of the litany of design, fairness, and constitutional flaws in the A.B. 71 approach compared with other states and the federal government makes it untenable to suggest that A.B. 71 is all about "conformity." California goes out of its way to depart from its own norms and the restraint practiced by other highly populated states in refraining from taxing foreign-source income. Instead, California prioritizes raising as much tax revenue as possible from U.S. multinationals without including some of the safeguards for avoiding punitive or double taxation provided by other states and the federal government. This is not conformity, but rather poorly designed, misleadingly marketed, and punitively applied corporate tax increases.

Justification 2: Businesses Do Not Pay Their Fair Share of Taxes

A second argument made by proponents is that businesses do not pay their fair share of taxes, and so the $600-million to $950-million-a-year corporate tax increase in A.B. 71 is justified.[30] The issue of what constitutes a "fair share" of taxes cannot be determined on a purely objective basis. A comparison with comparable states, however, is a good indicator of whether a state is in the mainstream or an outlier in terms of its corporate income tax burden.

Table 3 below shows a comparison of California with the other most populated states. Together, these states are the headquarter locations of most U.S. multinational corporations. California is at the highest end of the corporate tax rate spectrum on all the key metrics in Table 3.

First, California has the fourth-highest marginal corporate tax rate at 8.84 percent. Also, California has the highest marginal tax rate, 13.3 percent, on personal income taxes on corporate distributions or sales of corporate stock. Taken together, California and New Jersey are in a virtual tie as the states with the highest combined tax rates for corporate income and distributions.[31]

Even without A.B. 71, California is one of only three of the 20 most populated states (Maryland and New Jersey are the other two) that taxes either 25 percent of foreign dividends or 50 percent of GILTI. If A.B. 71 is enacted, California would impose the broadest state tax base on foreign income of any of those states, taxing 25 percent of foreign dividends and 50 percent of GILTI. Moreover, if both A.B. 71 and Biden's income tax proposals are passed, California would leap to the top of the list in combined federal and state taxes on capital gains at 57.6 percent.[32]

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[29] *See* A.B. 71. as amended in assembly Mar. 25, 2021, section 3(i)(3), amending Cal. Rev. & Tax. Code section 25110.1(i)(3) to read: "'Global intangible low-taxed income' has the same meaning as defined by Section 951A of the Internal Revenue Code, as enacted by the Tax Cuts and Jobs Act (Public Law 115-97), relating to global intangible low-taxed income, but *not taking into account any subtractions made pursuant to Section 1.951A-2(c)(7)* of Title 26 of the Code of Federal Regulations" (emphasis added).

[30] Reuven S. Avi-Yonah, David Gamage, and Darien Shanske, "This Is a Good Time for the Legislature to Invest in California by Taxing Large, Profitable Corporations," CalMatters (Feb. 24, 2021). The authors state: "Hence, A.B. 71 funds itself by means of a targeted tax increase that will be paid for only by the largest corporations best able to pay. This is an appropriate revenue source, as corporations have paid an ever-smaller share of their profits in taxes over the last several decades."

[31] Janelle Cammenga, "State Corporate Income Tax Rates and Brackets for 2021," Tax Foundation (Feb. 3, 2021); and Katherine Loughead, "State Individual Income Tax Rates and Brackets for 2021," Tax Foundation (Feb. 17, 2021).

[32] Garrett Watson and Erica York, "Top Combined Capital Gains Tax Rates Would Average 48 Precent Under Biden's Tax Plan," Tax Foundation (Apr. 23, 2021).

Table 3. Current State Taxation of Corporate Income and Distributions in Largest Population States

State	Top Marginal State Personal Income Tax on Capital Gains and Dividends	Top Marginal State Corporate Income Tax Rate	Combined State Tax on Corporate Income and Distributions	Combined Federal and State Capital Gains Tax Rates (Biden Tax Plan)****	Current Corporate Taxation of Foreign Income
California	13.3%	8.84%	22.14%	57.6%	25% of Foreign Dividends 50% of GILTI (in A.B. 71)
New York	8.82%	7.25%	16.07%	54.3%	None
New Jersey	10.75%	11.5%	22.25%	54.2%	5% of Foreign Dividends, 50% of GILTI
Arizona	4.5%	4.9%	9.4%	49.4%	None
Georgia	5.75%	5.75%	11.5%	49.2%	None
Virginia	5.75%	6%	11.75%	49.2%	None
Maryland	5.75%	8.25%	14%	49.2%	50% of GILTI
Missouri	5.4%	4%	9.4%	48.8%	None
Wisconsin	7.65%	7.9%	15.55%	48.8%	None
North Carolina	5.25%	2.5%	7.75%	48.7%	None
Illinois	4.95%	9.5%	14.45%	48.4%	None
Massachusetts	5%	8%	13%	48.4%	5% of Foreign Dividends 5% of GILTI
Ohio	4.8%	*	4.8%	48.2%	None
Michigan	4.25%	6%	10.25%	47.7%	None
Indiana	3.23%	5.25%	8.48%	46.6%	None
Pennsylvania	3.07%	9.99%	13.06%	46.5%	None
Texas	*	*	*	43.4%	None
Florida	*	4.46%	4.46%	43.4%	None
Washington***	*	*	*	43.4%	None
Tennessee	*	6.5%	6.5%	43.4%	5% of GILTI

* Texas, Florida, Tennessee, and Washington do not impose a personal income tax.

** Texas, Ohio, and Washington do not impose a corporate income tax. Each of these states impose a gross receipts tax or modified gross receipts tax at rates that are not comparable to income tax rates.

*** Does not reflect recent passage of Senate Bill 5096 by the Washington Legislature, which would impose an excise tax on long-term capital gains earned by certain individuals at the rate of 7 percent.

**** Garret Watson and Erica York, "Top Combined Capital Gains Tax Rates Would Average 48 Percent Under Biden's Tax Plan," Tax Foundation (Apr. 23, 2021).

Source: Council On State Taxation.

It is also very important when analyzing the business tax burden to look not just at corporate income taxes but also at the overall composition and level of state and local taxes imposed on businesses. In virtually every state, including California, the corporate income tax is the third- or fourth-largest tax imposed on business, trailing far behind property taxes and sales taxes on business inputs. When viewing all state and local taxes, businesses in California in fiscal 2019 paid about 40 percent of all state and local taxes.[33] And despite the focus on the erosion of the state tax base arising from profit shifting, business taxes in California as a share of all state and local taxes have been remarkably stable for the last two decades, the time frame in which most profit shifting has reportedly occurred.[34] In fiscal 2003 businesses in California similarly paid about 40 percent of all state and local taxes.[35]

Given California's high marginal corporate income and personal income tax rates, it is not surprising that California relies more on business taxes on income than most other states. Among the 20 most populated states, California levies the third-highest combined share of corporate income taxes and personal income taxes on business income (passthrough entities, partnerships, and sole proprietors) as a share of all state and local taxes on business (after New York and Massachusetts).[36] And the share of business income taxes has actually increased over the last 15 years. In fiscal 2004, business income taxes as a share of all California state and local taxes on business totaled 19.3 percent.[37] By fiscal 2019, business income taxes as a share of all California state and local taxes on business had grown to 22.8 percent.[38]

On balance, the argument that businesses in California do not pay their fair share of taxes is not borne out by the facts. Based on comparisons with other states, California ranks near the top in terms of highest corporate and personal income tax rates and tax bases on business among the most populated states.

Justification 3: GILTI Is Not Really Foreign-Source Income, but Displaced Domestic Income

The third of the proponents' justifications for A.B. 71 is that the addition of 50 percent of GILTI (as well as 40 percent of the section 965 repatriated dividends) to the California corporate income tax base is designed to recapture foreign-source income earned by U.S. multinationals that is essentially displaced domestic income. Based on this premise, proponents assert the foreign-source income should be properly treated as part of the domestic tax base, not the foreign tax base. Similarly, there is no requirement to include any

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33 Council On State Taxation and EY LLP, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2019" (Oct. 2020).

34 According to economist Kimberly A. Clausing, the period since 2000 has been the peak period of corporate base erosion and profit shifting — with about 85 percent of the alleged rise in annual revenue loss occurring during this period. Clausing, "The Revenue Effects of Multinational Firm Income Shifting," *Tax Notes*, Mar. 28, 2011, p. 1580, at tables 4 and 5. That study was conducted in the early 2010s, so the percentage has undoubtedly increased since then.

35 Robert Cline et al., "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in FY2003," COST and EY, at 10 (Jan. 2004).

36 COST and EY, "Total State and Local Business Taxes: State-by-State Estimates for FY 2019," *supra* note 33, at 22. To fully understand the scope of income taxes paid by businesses, one must analyze both the corporate income tax and personal income taxes borne by businesses. The personal income tax share of this equation has grown significantly over the past several decades as the advantages of limited liability company and partnership status became more apparent, encouraging business owners to adopt noncorporate forms of business organization. As a result, any statistic that reflects the corporate income tax only as a measure of business tax burden is misleading. *See* "Corporate and Pass-Through Business State Income Tax Burdens: Comparing State-Level Income and Effective Tax Rates," prepared for the State Tax Research Institute by PwC LLP (Oct. 2017); and Tax Foundation, "Business Tax Collections Within Historical Norms After Accounting for Pass-Through Business Taxes" (Apr. 15, 2021). The Tax Foundation has observed that levels of U.S. federal income tax collections on business income are within historical norms once the multidecade transition in business form (from C corporations to passthrough entities) is accounted for.

37 *See* Cline et al., "Total State and Local Business Taxes Nationally 1980-2004 and by State 2000-2004," COST and EY, at 7 (Apr. 12, 2005).

38 *See* COST and EY, *supra* note 36, Table 3, at 10. Indeed, between fiscal 2017 and 2019, California corporate tax revenues increased by 37 percent. This occurred at the same time federal tax revenues declined as the result of the corporate tax cuts in the TCJA. *See* COST and EY, *supra* note 36, Table 3 at 10; and COST and EY, "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2017," Table 3 at 10 (updated July 2019).

foreign sales that contributed to the production of the income in the sales factor of the apportionment formula because the income is really domestic-generated income. The premise is simple, but it's also demonstrably false.

The derivation of the conclusion that "GILTI is equivalent to displaced domestic income" comes from several articles written by two law professors in 2019 and cited repeatedly by the staffs of both House committees.[39] The logic of the argument is as follows: First, GILTI was developed by the U.S. Congress to identify the amount of profit shifting in global commerce. Therefore, GILTI is a rough proxy for displaced domestic income, and any income that is GILTI is not foreign-source income at all.[40] Second, the 50 percent of GILTI taxed by the U.S. government (and conformed to by California in A.B. 71) represents the approximate share of global profit shifting that was shifted out of the United States.[41] Third, if this amount was shifted out of the United States, the U.S. government *and* the states are allowed to sweep 50 percent of GILTI back into federal and state tax bases.[42] Fourth, if GILTI really represents displaced domestic income, the states can include GILTI in the corporate income tax base without including foreign factor representation in the apportionment method.[43]

The first assertion, that GILTI is the rough equivalent of displaced domestic income, is the linchpin of the entire justification, both for the inclusion of GILTI in the state tax base and the exclusion of foreign factors from the apportionment formula. This claim (along with a similar one discussed below for section 965 deemed repatriated income) is critical to the justification of the $600-million to $950-million-a-year corporate tax increase and is accepted almost verbatim by both Assembly committees' staff members without independent analysis or verification. According to the report of the Assembly Committee on Revenue and Taxation:

> As noted earlier, GILTI identifies shifted income by formula. If GILTI identifies $10 billion in a CFC in Ireland that was not really earned there, part of the $10 billion may have been shifted from the US and part of the $10 billion may have been shifted from another country like Germany. The 50 percent is used as a reasonable estimate of how much of the shifted income came from the US.[44]

One would think that for a "factual" finding — so important that it provides the underpinning for a radical shift from how California has taxed foreign-source income for the last 30 years — proponents would cite language in the TCJA itself or at least in the legislative history confirming this conclusion. But there is no such citation in either the law professors' articles or in the committee's report. The reason is straightforward. Congress

[39] Shanske and Gamage, "Why States Can Tax the GILTI," *State Tax Notes*, Mar. 18, 2019, p. 967; and "States Should Conform to GILTI, Part 3: Elevator Pitch and Q&A," *Tax Notes State*, Oct. 14, 2019, p. 121.

[40] Shanske and Gamage, "States Should Conform to GILTI, Part 3: Elevator Pitch and Q&A," *supra* note 39, at 122-123. As the authors conclude, "GILTI is a tool for identifying shifted profits" (at 122); and "Including apportioned GILTI income is taxing domestic — not foreign-sourced income" (at 123). *See also* Avi-Yonah, Gamage, and Shanske, *supra* note 30.

[41] The claim that U.S. profit shifting constitutes 50 percent of global profit shifting is based on a footnote in an article by Shanske and Gamage. The assertion is somewhat dubious since the authors' cited studies report U.S. profit-shifting shares of 37 percent and 42 percent, which the authors round up to 50 percent. *See* Shanske and Gamage, "Why States Can Tax the GILTI," *supra* note 39, at 970.

[42] Referring to GILTI, the staff report states: "As such, those earnings should have always been included as part of the water's edge election." Assembly Committee on Revenue and Taxation, A.B. 71 Bill Analysis, at 7 (Apr. 19, 2021).

[43] Shanske and Gamage, "Why States Can Tax the GILTI," *supra* note 39. Shanske and Gamage use this argument to disregard decades of jurisprudence on the need for fair apportionment and factor representation in allocating income between states. This leads them to the conclusion that states can do virtually anything they want when it comes to factor representation and the unsupported assertion that *zero* factor representation is permissible as well. For more on the constitutional requirements relating to factor representation, see Frieden and Donovan, *supra* note 10. The foreign sales factor representation that goes unrecognized is very large. In 2018 the companies within the S&P composite index (over 95 percent based in the United States) had aggregate sales of $11.35 trillion, of which 42.9 percent — or about $4.87 trillion — were foreign sales. Howard Silverblatt, "S&P 2018: Global Sales" (Aug. 2019).

[44] *See* Assembly Committee on Revenue and Taxation, A.B. 71 Bill Analysis, *supra* note 42, at 7. *See also* Assembly Committee on Housing and Community Development's A.B. 71 Bill Analysis, *supra* note 16, at 14.

never intended GILTI to be equated with displaced domestic income and never said so in print or otherwise.[45]

But there is no need to get bogged down in speculation. It is readily apparent from the formula for deriving GILTI that it cannot possibly be equated with displaced domestic income. The key elements in calculating GILTI are quite simple, and there are only two of them. The federal GILTI calculation starts with the inclusion of all foreign income of the subsidiaries of U.S. multinationals (controlled foreign corporations). The second step is the allowance of the QBAI deduction. The QBAI deduction represents 10 percent of the CFCs' *tangible* property investments in foreign countries. That's it. That's the whole formula for determining what constitutes GILTI.[46]

Even a cursory analysis of this formula reveals that it does not, and indeed cannot, identify the share of foreign-source income that is attributable to displaced domestic income (or profit shifting). A broad cross section of industries have limited or modest capital investment outside the United States (and thus minimal QBAI deductions). For these businesses, physical investments are not central to their business models or profit-making activities, and therefore GILTI by default represents not displaced domestic income, but all or a very high share of their foreign-source income. For instance, technology and information companies rely extensively on digital business models, not on physical operations. Financial institutions such as banks and insurance companies similarly do not rely on physical assets for their wealth-creation activities. The fast-growing services sector — including global engineering, accounting, law, business services, and personal services — also generally has a low ratio of physical capital to income. Even many global manufacturers, which one would expect to have extensive capital investments in plant and equipment (and thus QBAI), frequently rely on outsourcing to third-party suppliers in Asia or other lower-wage countries. (Capital investments by third parties are not included in QBAI.) For all these business sectors, substantive business operations with large workforces can be carried out in foreign countries with limited or modest investments of physical capital.

The QBAI "carveout" from GILTI arbitrarily provides a larger deduction for more capital-intensive industries such as oil production and refining, transportation, construction, and some manufacturing sectors.[47] It does little to identify "substance" in foreign operations in more labor or knowledge-intensive industries or accord value to the foreign country workforces of any U.S. multinationals. According to the U.S. government's Bureau of Economic Analysis, in 2018 majority-owned foreign affiliates of U.S. multinationals employed 14.4 million workers, accounting for 33.5 percent of the global employment of U.S. multinationals.[48]

This shortcoming of the QBAI formula has been recognized and highlighted by the OECD in its ongoing pillar 2 project. The OECD's pillar 2 project is seeking to gain international consensus for a global minimum tax similar to the U.S. GILTI regime.[49] However, the OECD has proposed using a formulaic substance-based carveout with a *payroll* and tangible asset component in lieu of the QBAI deduction. As the OECD concludes:

> By acknowledging the contributions of both employees and tangible assets, a combined carve-out for payroll and tangible assets provides for a more level playing field by allowing a meaningful carve-out for MNEs [multinational enterprises] with varying substance

[45] Nor did Congress, unlike the states, need to determine that GILTI somehow represents displaced domestic income to tax it. The federal government can broadly impose corporate income taxes on a "residence" basis if it so chooses (on all income wherever earned), whereas the Constitution limits states' power to tax multistate businesses to a "source" basis (on only income earned from sources within that state). The federal GILTI calculation is essentially a global minimum tax at 13.125 percent, with a carveout for a 10 percent return on investments of tangible property (QBAI). But a minimum tax doesn't work if there is no "minimum" established — if there is no credit for taxes paid that identifies if the minimum has been exceeded. FTCs are utilized at the federal level, but not the state level. So a minimum tax on the foreign-source income of multinational businesses at the state level is not allowed and not workable.

[46] 26 U.S.C. section 951A. For a few other smaller modifications to the GILTI calculation, see Donovan, *supra* note 9, at 324.

[47] Jake Frankenfield, "Capital Intensive," Investopedia (updated Mar. 19, 2020).

[48] *See* Bureau of Economic Analysis, Activities of U.S. Multinational Enterprises, 2018.

[49] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar Two Blueprint" (Oct. 14, 2020).

> profiles, including labour-intensive and asset-intensive businesses. Whereas a carve-out based on a single factor, either payroll or tangible assets, would end up favouring one set of industries over another.[50]

What then does GILTI stand for at the state level? For a broad cross section of U.S. multinationals with limited or modest physical investments (and thus a minimal QBAI deduction), GILTI more closely approximates total foreign-source income than it does displaced domestic income. For other businesses, with more significant capital investments (QBAI) abroad, GILTI identifies the businesses' "nonroutine" profits as measured by one particular metric (returns on capital investment above 10 percent), but it still doesn't distinguish between low-tax and high-tax operations.

Upon reflection, it makes complete sense that Congress would not assign too much weight to the definition of GILTI, which is, after all, just an intermediate calculation in a string of numbers that determines how much foreign-source income is subject to tax federally under the new GILTI regime. For federal purposes, after the amount of GILTI is determined, several additional steps must be calculated before a corporate taxpayer reports its taxable foreign-source income. First, a section 250 deduction of 50 percent (changing to 37.5 percent in 2026) is applied to the amount. Then, a tax of 21 percent is multiplied by the quotient. And finally, and most importantly, the taxpayer is allowed to take an 80 percent FTC against the calculated tax to reflect taxes paid on the same income in other countries. That last step is critical, far more important than the intermediate calculation of GILTI. Since the goal is to discourage taxpayers from locating assets in low- or no-tax foreign jurisdictions, the whole process is somewhat meaningless if it stops at one of the intermediate calculation steps.

This is exactly the point made earlier in this article. A state (such as California in A.B. 71) that includes GILTI in its tax base, but does not allow for FTCs, significantly deviates from the overall federal calculation, and the state has no idea whether the GILTI is low-taxed or high-taxed. If a CFC reports $100 million in GILTI, the state has no way of knowing whether the CFC earned the income in a country with a 0 percent rate, a 10 percent rate, or a 25 percent rate. Without that information, the GILTI classification is rather meaningless and certainly cannot determine whether foreign income derives from real substantive operations or more artificial profit-shifting activities (which the proponents refer to as displaced domestic income).

While we have focused on GILTI so far in this section, the proponents of A.B. 71 make a similarly disingenuous defense of the retroactive taxation of 40 percent of section 965 deemed repatriated dividends. They claim that 40 percent of foreign dividends over a 30-year period is also displaced domestic income from the United States. According to Assembly Committee on Revenue and Taxation staff:

> This bill requires a taxpayer that has made a water's edge election to include 40 percent of any repatriation income. As noted earlier with respect to GILTI, this bill attempts to make a reasonable determination as to how much has been shifted out of the US. The 40 percent for repatriation is lower than the 50 percent used for GILTI, in part, because some of that income might have been earned abroad and just left abroad.[51]

Foreign dividends, when repatriated, actually represent all the worldwide income of the foreign subsidiaries of U.S. multinationals earned in a given year. There is no QBAI or any other deduction that reduces this amount. The Assembly Committee has identified 40 percent of foreign dividends as attributable to profit shifting from the United States by U.S. multinationals. Based on the committee's acceptance of the assumption that one-half of global profit shifting is the U.S. share,[52] this would mean that 80 percent of the worldwide income of foreign subsidiaries

[50] *Id.* at 95, and section 4.3.

[51] *See* Assembly Committee on Revenue and Taxation, *supra* note 42, at 8. The Assembly Committee staff also cite Shanske and Gamage to substantiate this finding: Shanske and Gamage, "Why (and How) States Should Tax the Repatriation," *State Tax Notes*, Apr. 23, 2018, p. 317.

[52] *See* Assembly Committee on Revenue and Taxation, *supra* note 42, at 7.

of U.S. multinationals over the 30-year period is attributable to (global) profit shifting. Of course, this proposition is nonsensical on its face but illustrates the lack of rigorous analysis applied to the proponents' claim that all the income A.B. 71 adds to the state income tax base is "domestic" in nature.

It does not help that discussions of profit shifting are frequently saddled with overblown rhetoric and methodological challenges. Profit shifting is an international problem that has garnered the attention of most nations around the world, including the United States. But that doesn't mean a consensus exists for how to measure profit shifting or the degree to which it affects global tax collections. At the end of its first base erosion and profit-shifting project in 2015, the OECD provided an estimate of the lost corporate income tax revenue from profit shifting that was much lower than some other studies:

> Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, today we know that the fiscal effects of BEPS are significant. The findings of the work performed since 2013 highlight the magnitude of the issue, with global corporate income tax (CIT) revenue losses estimated between 4 percent and 10 percent of global CIT revenues.[53]

Similarly, economists Jennifer Blouin and Leslie Robinson, in a widely publicized 2020 analysis of the inaccuracy of one of the more prominent high-end estimates of profit shifting, found that the study had seriously overstated profit shifting because of extensive "double-counting." The economists concluded: "Our correction reduces an estimate of the U.S. fiscal effects of BEPS from 30-45 percent to 4-8 percent of corporate tax revenues lost to BEPS activity of [MNEs]."[54]

In conclusion, for a large cross section of American multinationals, the addition of GILTI to the state corporate tax base results in the inclusion of all or substantially all of their foreign-source income, with no means for determining if some or any of the income is attributable to profit shifting. For other more capital-intensive businesses, GILTI represents their nonroutine profits, but does not delineate whether they paid low or high taxes on this income. The proponents of A.B. 71, in their understandable frustration with the elasticity of international tax rules and the ability of some companies to avoid paying a full share of taxes on some of their profits have gone to the other extreme and promoted an irrational theory that ignores the scale, substance, and complexity of global trade and commerce.[55] The simplistic approach of the proponents of A.B. 71 — in equating the concept of 50 percent of GILTI and 40 percent of deemed repatriated dividends with displaced domestic income (from the United States) to justify their inclusion in the state tax base — is at best extremely misleading and ill-informed, and at worst a solution that is more harmful than the problem.

The Biden Administration's Corporate Tax Reform Plan Would Render A.B. 71 Obsolete and Punitive

President Biden released his proposed corporate tax reform plan, the Made in America Tax Plan, on April 7. One of the key provisions in Biden's plan is a significant increase in the tax rate and tax base of foreign-source income earned by U.S. multinationals. The ambitious aim of the Biden plan is to not only address profit shifting but also impose a residence-based tax on the worldwide income of U.S. multinationals.

The enactment of the foreign-source income provisions in the president's plan, in whole or substantial part, would render A.B. 71 outdated and punitive. If federal corporate tax reform is enacted, the debate would almost immediately shift from whether U.S. multinationals are paying enough in taxes to whether they are paying too

[53] OECD, "Measuring and Monitoring BEPS, Action 11 — Final Report," at 15 (Oct. 5, 2015).

[54] Blouin and Robinson, "Double Counting Accounting: How Much Profit of Multinational Enterprises Is Really in Tax Havens?" SSRN (Sept. 1, 2020).

[55] Interestingly, Shanske and Gamage do note in one of their earlier articles on GILTI some of the critiques of the GILTI and QBAI calculations, but then downplay those inadequacies in subsequent articles. *See* Shanske and Gamage, "Why States Should Tax the GILTI," *Tax Notes State*, Mar. 4, 2019, p. 752.

much in taxes, particularly in relation to the global tax burden on their foreign competitors.

How would the Biden administration's corporate tax reform plan change GILTI? And why would it immediately make A.B. 71 obsolete? The Biden administration's GILTI reform is rather simple in design but far-reaching in its implications. First, the Biden plan broadens the base of GILTI to encompass all a U.S. multinational's foreign-source income by eliminating the QBAI deduction. Second, the Biden plan calculates GILTI and the associated FTCs on a country-by-country basis instead of an aggregate global basis, essentially eliminating the ability of companies to offset income in some countries with losses in other countries. Finally, the Biden plan raises the tax rate on GILTI to 21 percent from its current effective tax rate of 13.125 percent. Taken together, these steps would radically restructure GILTI from a global minimum tax into a full-blown residence-based tax on the worldwide income of U.S. multinationals.[56]

Interestingly, the Biden plan does not attempt to modify GILTI to make it a more accurate mechanism for identifying and separating profit-shifting income from other foreign-source income. The Biden plan steers clear of the very difficult task of distinguishing between profit shifting without economic substance and moving actual production and jobs to take advantage of lower tax rates offered by many countries. As the head of the Treasury Department's Office of Tax Analysis wrote, "The United States would, for its own multinationals, play the role of tax collector of last resort: it would collect the taxes that foreign countries chose not to collect" on the foreign-source income of U.S. multinationals.[57]

The implications of the Biden plan for A.B. 71 are clear. If the foreign tax provisions of the Biden plan are implemented, the rationale for enacting A.B. 71, however contrived to begin with, would be swept away, as there would be little or no displaced domestic income for California to add to its tax base. As Biden's Made in America Tax Plan states:

> The President's plan would dramatically reduce the significant tax preferences for foreign investment relative to domestic investment that are embedded in both the current GILTI and FDII regimes, including a near-elimination of profit shifting. . . . Estimates by the Treasury Department and the Joint Committee on Taxation confirm that the international tax reforms along the lines of the President's proposals can essentially end profit shifting.[58]

Under this scenario, California under A.B. 71 would end up taxing the entire worldwide income of foreign subsidiaries of U.S. multinationals, or at least half after California's 50 percent deduction. No reduction would be allowed based on the FTC (which states don't conform to) nor would any allowance be made for foreign factor representation (which A.B. 71 prohibits). Moreover, if federal legislation is enacted in 2021, the federal effective date would likely coincide with the state effective date in 2022.

Without justification for expanding the state tax base to include half of foreign-source income (without foreign factor representation), California would end up imposing a punitive corporate tax increase applicable only to U.S. multinationals. Given the gap between the Biden administration's proposal for a 21 percent global minimum tax rate and the OECD pillar 2's initial focus on a 12.5 percent global minimum tax rate,[59] the higher combined federal/state (including California

[56]*See* U.S. Treasury, The Made in America Tax Plan (Apr. 7, 2021). It's not clear at this point how the Biden administration proposes to get to 21 percent, as it could reach that goal by reducing the section 250 deduction, raising the rate, limiting a portion of the FTC, or some combination of all three.

[57]Clausing, Emmanuel Saez, and Gabriel Zucman, "Ending Corporate Tax Avoidance and Tax Competition: A Plan to Collect the Tax Deficit of Multinationals," SSRN (revised Jan. 2021).

[58]The Made in America Tax Plan, *supra* note 56, at 11, 13.

[59]At this time, it is not clear what tax rate the OECD's pillar 2 inclusive framework will adopt for its global minimum tax. The initial assumption is a 12.5 percent rate; *see* OECD, "Tax Challenges Arising From Digitalisation — Economic Impact Assessment," at 16, 18 (Oct. 12, 2020). On the political difficulties of raising the OECD global minimum tax rate to achieve parity with a U.S. rate of 21 percent, see Todd Buell, "Biden Plan Adds Momentum to Int'l Talks, EU Parliament Says," *Law360*, Apr. 29, 2021. No other country in the world other than the United States currently imposes a tax on active foreign business income. Moreover, the competitive disadvantage for U.S. multinationals may include both a higher global minimum tax rate and a broader tax base given the OECD's proposed formulaic substance-based carveout with payroll and tangible asset components from its global minimum tax. *See* OECD, *supra* note 49, at section 4.3.

under A.B. 71) tax rate on all or part of the worldwide income of U.S. multinationals would lead to a significant competitive disadvantage for U.S. multinationals.

One of the biggest risks of the Biden corporate tax reform plan, if enacted, is not that it will fail to deter profit shifting and low-tax-rate competition, but that it will succeed, but only by unilaterally leapfrogging global minimum tax rates imposed by other countries. If it does so, U.S. concern over profit shifting and low-tax-rate competition will give way to a reality in which the U.S. government and any conforming states are creating a significant competitive disadvantage for U.S. multinationals relative to foreign multinationals from China, Germany, Japan, India, and other countries.[60]

U.S.-based corporations make up 22 of the largest 50 multinationals in the world and 38 of the largest 100.[61] California, as a stand-alone economy, has the fifth-largest GDP in the world, behind Germany and ahead of India.[62] Any action California takes regarding taxing or refraining from taxing foreign-source income has an impact on U.S. fiscal and tax policy.

Granted, the political prospects of the Biden corporate tax reform plan are still uncertain, especially given the Democrats' razor-thin majorities in the Senate and House. The foreign-source income proposals are not only far-reaching but are part of a sweeping $4 trillion package of infrastructure and social spending programs offset by another $4 trillion of corporate and personal income tax increases.[63] There is not yet legislative language that enables a review of the details of the proposals. The plans could flounder given the enormity of the fiscal and tax issues simultaneously addressed. Nonetheless, many observers believe the GILTI provisions, in some form, have a clearer path to enactment than some of the other changes (for example, the top marginal corporate tax rate).

The choice is a clear one for the California State Legislature: It should either reject A.B. 71 on its own merits for the reasons discussed in the earlier sections of this article or at least postpone consideration of A.B. 71 until the state can factor in the outcome of federal tax reform in the United States and international tax reform developing in other nations under the OECD's pillar 2 project.

Conclusion

A.B. 71 is not all about or even primarily about corporate income taxes. It is principally about finding a solution (and a funding source) to address a growing homelessness crisis in California. Our critique of the tax provisions of the proposed legislation is in no way meant to deter the California State Legislature from addressing the serious homelessness problem in the state.

However, it is counterproductive for California to dedicate a revenue source to funding homelessness solutions that is both unstable and detrimental to the overall economic climate in the state. If A.B. 71 passes, given its many constitutional infirmities, it will be tied up in litigation in the California courts for years, with the very real possibility that some or all the revenue raised could eventually be refunded to corporate taxpayers, leaving a huge future state budget deficit.

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[60] It is not that the United States or California specifically intend to harm U.S. multinationals; it's just that each country can impose a global minimum tax rate only on its own multinational businesses, not on those of other countries. If the U.S. government unilaterally imposes a global minimum tax rate that is not matched by other advanced nations, then a rate disparity and competitive disadvantage for U.S. multinationals occurs. If California and other states include foreign-source income in the state tax base, then the rate disparity widens. This is also why profit shifting needs to be addressed at the national level, not the subnational level. Only at the national level can the government balance limiting competition from low-tax countries with avoiding a global minimum tax rate that disadvantages U.S. multinationals. Only at the national level can the government try to achieve rate and competitive parity with other countries' treatment of their own multinationals.

[61] Andrea Murphy et al., "Global 2000: The World's Largest Public Companies," *Forbes*, May 13, 2021.

[62] Based on fiscal 2019 data, California has the largest economy in the United States, with approximately $3.2 billion gross state product. *See* Bureau of Economic Analysis, "Gross Domestic Product by State, Fourth Quarter and Annual 2019" (Apr. 7, 2020). As such, globally, California has the fifth-largest economy, between Germany, with $3.9 trillion reported GDP, and India, with $2.9 trillion GDP. *See* World Bank, 2019 GDP (current U.S. dollar).

[63] *See* the Made in America Tax Plan, *supra* note 56. *See also* "Fact Sheet: The American Families Plan," White House Briefing Room (Apr. 28, 2021).

Also, the fundamental landscape of national and international corporate income taxation is on the verge of momentous change. If California blindly steps out in front, it could cause debilitating competitive damage not just to U.S. businesses relative to their foreign competitors but also to California's standing relative to other states. California already imposes the second-highest combined tax on corporate income and corporate distributions among the 20 most populated states in the country, and only two other states in that group tax more than a de minimis amount of GILTI.

If A.B. 71 is enacted, it will add to California's growing reputation as a high income tax state at precisely the wrong time. For the first time in its history, California lost a seat in Congress, reducing its 53 house districts to 52.[64] This reflects recent population shifts but could also be a harbinger that California is at an inflection point in terms of maintaining its long-standing reputation as a great environment in which to live and to create businesses.

Caution is certainly a reasonable course of action. While there may be an urgency in addressing the homelessness crisis, there is no similar urgency in finding a funding source for it. The proposed corporate tax increases come at a time when Democratic Gov. Gavin Newsom's January 2021 budget touted record reserves of $22 billion, including a $15.6 billion balance in California's rainy day fund.[65] Also, another $15 billion windfall is expected to result from increased tax revenue.[66] California's budget outlook is so optimistic that the state may be required to issue refunds to residents under the Gann limit, a constitutional amendment adopted by California voters in 1979 that limits legal spending by California state and local governments. It would be only the second time in more than 40 years that the state would be required to issue refunds under this provision.[67]

Fortunately, A.B. 71 is still proposed and not enacted legislation. The California State Legislature should reject A.B. 71 on a stand-alone basis. Alternatively, it should put the legislation on hold pending the outcome of the Biden administration's corporate tax reform legislation. ■

[64] *See* Ben Christopher, "California Loses Congressional Seat for First Time," CalMatters (Apr. 26, 2021).

[65] *See* Office of Governor Gavin Newsom, "Governor Newsom Proposes 2021-22 State Budget" (Jan. 8, 2021).

[66] *See* Romy Varghese, "California Weighs How to Spend Surprise Windfall in a Pandemic," *Bloomberg*, Jan. 8, 2021.

[67] California Gov. Gavin Newsom, "Governor Newsom's California State Budget Briefing," YouTube, at 1:17 (Jan. 8, 2021).