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January 22, 2019

Director John J. Ficara
New Jersey Division of Taxation

Deputy Director Denise Harding
Office of Counsel Services
New Jersey Division of Taxation

Re: COST's Concerns with TB-85R, issued December 24, 2018 ("Tax Conformity to IRC Sec. 951A (GILTI) and IRC Sec. 250 (FDII)")

Dear Director Ficara and Deputy Director Harding,

On behalf of the Council On State Taxation (COST), I am writing to express concerns with the Division's guidance provided to taxpayers in TB-85R, issued on December 24, 2018, concerning the treatment of global intangible low-taxed income (GILTI) under IRC Sec. 951A and the deductions allowed under IRC Sec. 250 for GILTI and foreign derived intangible income (FDII). In TB-85R, the Division stated its intention to promulgate regulations consistent with this guidance. COST urges the Division to address the concerns expressed below when promulgating regulations addressing GILTI and FDII.

About COST

COST is a nonprofit trade association consisting of approximately 550 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

COST's Analysis of Federal Tax Reform and GILTI

Regarding GILTI, COST co-authored a research paper on the policy and constitutional ramifications of the state taxation of this new classification of foreign source income.[1] The paper analyzes how the state taxation of GILTI is fundamentally different than the federal taxation of GILTI both from a policy and a practical outcomes perspective. In particular, states do not allow foreign tax credits, the mechanism that limits the taxation of GILTI at the federal level to only "low-taxed" foreign income. The state taxation of GILTI also undermines the principle of "waters-edge" taxation and raises constitutional concerns. For these reasons, the paper recommends states decouple from GILTI.

[1] See *State Taxation of GILTI: Policy and Constitutional Ramifications*, by Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroian, and Chelsea A. Wood, State Tax Notes, pp. 315-335, October 22, 2018.

COST's Recommendation for an Apportionment Methodology to Use with GILTI

For states that do not decouple from GILTI (such as New Jersey), the paper sets forth the need for appropriate apportionment factor representation consistent with methodologies historically used for apportioning income earned by multistate and multinational businesses. To that end, we recommend the following formula be adopted to ensure that the receipts (and where appropriate property and payroll) factors that contribute to GILTI are properly reflected in the apportionment method:

- 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 controlled foreign corporation (CFC) in a multi-tiered foreign chain. Not only is this the appropriate answer in terms of "matching" of factors and income base, but it also mirrors the federal income tax computation of allowable foreign tax credits regarding GILTI and subpart F income.

- The sales factor adjustment in a factor representation approach for GILTI should include the *gross foreign 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 representation works in relation to domestic-source income. 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".

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

This recommended approach not only mirrors the federal approach relating to the allocation of foreign tax credits to GILTI, but is consistent with the Multistate Tax Commission's model approach for factor representation of certain categories of 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".[2]

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[2] Multistate Tax Commission, "Proposed Model Statute for Combined Reporting," as amended by MTC section 5(A)(i), (July 29, 2011).

TB-85R's Apportionment Methodology Deviates from Conventional Norms for Apportioning Multistate Corporate Income and Fails to Equitably Apportion GILTI and FDII

New Jersey takes a fundamentally different approach to apportioning GILTI and FDII in TB-85R. In the case of GILTI, instead of allowing the taxpayer to include in the sales factor denominator the foreign receipts that contributed to GILTI in the year at issue, the Tax Division adopts an entirely novel apportionment methodology (using the ratio of New Jersey's gross domestic product (GDP) over the total GDP of every U.S. state (and the District of Columbia) in which the taxpayer has economic nexus) that has absolutely nothing to do with either the production of GILTI or the taxpayer's presence in New Jersey. The effect of this approach is to deny the taxpayer the inclusion of the very foreign receipts that contribute to the production of GILTI. The Division acknowledges this result in the Bulletin by stating "Taxpayers may not look through to the underlying sales when determining how to allocate GILTI and FDII…"

With regard to GILTI, the Division's Technical Bulletin offers only a very brief explanation for why an entirely new apportionment method is required. The Technical Bulletin states that "GILTI and FDII are a hybrid of different income items. GILTI, by design, constitutes displaced U.S. income at least in part…" The Division's presumption is that GILTI is not really foreign source income, but is better characterized as "displaced U.S. income" that has escaped taxation (in the words of the Bulletin) through "abusive offshore tax sheltering of income". However, this analysis fundamentally misconstrues what GILTI represents, particularly at the state level where no foreign tax credits are allowed to limit its impact to income that is not taxed or only taxed at low rates in foreign countries. For state tax purposes, GILTI represents all or a very large proportion of the foreign income of many U.S. multinationals, particularly those companies providing services, financial services, or selling tangible products with only modest or depreciated plant and equipment outside the United States.[3]

To illustrate this point, consider that 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.[4] 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.

The Division needs be more forthright in acknowledging what the taxation of GILTI represents – the vast expansion of its water's edge combined reporting regime (beginning in 2019) to tax foreign source income. GILTI is based on some or virtually all of the income of the foreign subsidiaries (CFCs) of U.S. multinational corporations, and fair apportionment of GILTI dictates that the underlying sales of the CFCs related to the production of GILTI be included in the sales factor denominator. The "separate special accounting method" put forth in the Technical Bulletin treats GILTI differently than domestic income (by excluding the receipts relating to the foreign income) and is clearly discriminatory. Further, the ratio of New Jersey's gross domestic product over the total GDP of every U.S. state in which the taxpayer has

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[3] See generally *State Taxation of GILTI: Policy and Constitutional Ramifications*, by Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroian, and Chelsea A. Wood, State Tax Notes, pp. 315-335, October 22, 2018.
[4] See S& P Foreign Sales Report (Aug. 16, 2018).

economic nexus in no way reflects the business activity giving rise to GILTI, and therefore produces a result that is not rationally or fairly related to the taxpayer's business in the state.

The Division is certainly correct that this new category of taxable income (GILTI) must be apportioned to satisfy statutory and constitutional requirements. But the Technical Bulletin inappropriately adopts a purely domestic (U.S.) factor representation method for foreign source income that is not even tied to each impacted company's New Jersey operations. This approach is not only bad public policy but likely unconstitutional as it violates the U.S. Constitution's Commerce Clause requirements that the taxpayer's liability be rationally related to the taxpayer's business in the state, and that foreign commerce not be discriminated against in favor of domestic commerce.

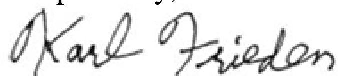
With respect to FDII, the Technical Bulletin's approach is similarly flawed, although for different reasons. FDII is related to U.S. income, and this new federal provision was designed to provide a tax deduction as an incentive for taxpayers to maintain intangibles and other factors of production in the U.S. to produce foreign sales (as opposed to locating these factors of production abroad). As such, there is no support for separating it from the apportionment of all the taxpayer's other U.S. income merely because there is now a deduction under IRC Sec. 250 for FDII. The proposed "separate special accounting method" is discriminatory and fails to reflect the business activity giving rise to this category of U.S. income.

Finally, the Technical Bulletin provides that deductions under IRC Sec. 250 "are allowed only to the specific taxpayer that included the respective GILTI and FDII income on its federal and New Jersey CBT returns, and that actually took the deductions for federal tax purposes." While this guidance is unclear, to the extent that it purports to disallow a GILTI deduction under IRC Sec. 250 while including GILTI in the New Jersey tax base, it violates the intent of the GILTI deduction at the federal level to produce a lower effective tax rate for this category of foreign income. Further, it violates the intent of the New Jersey General Assembly to commensurately reduce the state's effective tax rate on GILTI.

Conclusion

For the reasons outlined above, COST urges the Division to reject the approach taken in this Bulletin and promulgate regulations that provide for a fair apportionment of GILTI and FDII that reflects the actual receipts that contribute to the production of the income. Please contact me with any questions regarding COST's analysis of the New Jersey methodology and/or the very different approach recommended by COST.

Respectfully,



Karl A. Frieden

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director