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Karl A. Frieden
Vice President, General Counsel
(202) 484-5215
kfrieden@cost.org

September 17, 2019

Director John J. Ficara,
Alan S. Kline, Counsel to the Director
New Jersey Division of Taxation

Re: COST's Comments on TB-92, issued August 22, 2019 ("Sourcing IRC Sec. 951A (GILTI) and IRC Sec. 250 (FDII) Replacing TB-85 (R)")

Dear Director Ficara and Counsel Kline:

On behalf of the Council On State Taxation (COST), I am writing to comment on the Division's guidance provided to taxpayers in TB-92, issued August 22, 2019, concerning the sourcing of global intangible low-taxed income (GILTI) under IRC Sec. 951A and foreign derived intangible income (FDII) under IRC Sec. 250. In TB-92, the Division stated its intention to promulgate regulations addressing the topics covered by the Technical Bulletin. COST urges the Division to address the concerns expressed below when promulgating regulations addressing the allocation of GILTI and FDII under New Jersey law.

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 State Conformity with GILTI

COST recently co-authored a research paper on the policy and constitutional ramifications of the state taxation of GILTI.[1] The paper analyzed how the state taxation of GILTI is fundamentally different than the federal taxation of GILTI from both 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 "water's-edge" taxation and raises constitutional concerns. For these reasons, COST recommends states decouple from GILTI. Indeed, all large corporate headquarter states other than New Jersey have either decoupled fully or 95% from GILTI. New York was the latest to do so when it decoupled from 95% of GILTI in legislation enacted in June 2019.

[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.

This letter will provide COST's recommendation for a fair and constitutionally valid apportionment method for New Jersey to use with GILTI. If New Jersey maintains its current proposed methodology for apportioning GILTI – allowing the inclusion of net GILTI amounts in the denominator of the receipts factor – we will propose a clarification to resolve an ambiguity in TB-92. The letter will also recommend an apportionment methodology for New Jersey to use with FDII. Finally, we are also attaching to this letter "Comments on Technical Bulletin 92" from the STAR Partnership that recommend the same approach as COST for how New Jersey should apportion GILTI and FDII.

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

For states that do not decouple from GILTI, COST has co-authored another research paper that concludes the fair and constitutionally required allocation method for GILTI would allow the taxpayer to include the underlying gross receipts from the controlled foreign corporations (CFCs) that produced the GILTI amounts to be included in the denominator of the receipts factor.[2] In TB-92, issued on August 22, 2019, New Jersey revoked the allocation methodology for GILTI that had been promulgated in TB-85 (R) issued on December 24, 2018. COST commends New Jersey for responding to the concerns of corporate taxpayers with the apportionment formula for GILTI set forth in TB-85(R) and replacing that methodology with a different approach in TB-92. The original apportionment methodology was based on the ratio of New Jersey's gross domestic product (GDP) over the total GDP of every state in which the taxpayer had economic nexus. COST believes that methodology was out of sync with the approach taken in every other state, highly distortive, not reflective of either the corporate taxpayer's actual presence in the state or the foreign factors that contributed to the production of the GILTI amounts, and is unconstitutional. The revised allocation formula under TB-92 that allows the net amount of GILTI to be included in the denominator of the receipts factor is a significant improvement over the prior methodology.

However, we believe that the revised New Jersey formula set forth in TB-92 does not go far enough to provide a fair and constitutionally permissible allocation method. As we stated in our August 2, 2019 meeting with the Division and in our January 22, 2019 letter to the Division,[3] we believe the fair and constitutionally required allocation method for GILTI would allow the taxpayer to include the underlying gross receipts from the CFCs that produced the GILTI amounts in the denominator of the receipts factor. Otherwise, New Jersey would end up taxing foreign commerce (GILTI) less favorably than domestic commerce (other domestic-based income of the New Jersey taxpayer) by allowing only "net" receipts to be included in the apportionment formula in connection with foreign source income while allowing "gross" receipts in connection with domestic source income in violation of the U.S. Constitution's Foreign Commerce Clause.[4]

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[2] Karl A. Frieden and Joseph X. Donovan, "Where in the World Is Factor Representation For Foreign-Source Income," *State Tax Notes*, pp. 199-218, April 15, 2019.

[3] Karl Frieden letter to Director John J. Ficara and Deputy Director Denise Harding, "Re: COST's Concerns with TB-85R, issued December 24,2018 ("Tax Conformity to IRC Sec. 951A (GILTI) and IRC Sec. 250 (FDII)")", January 22, 2019.

[4] See *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992).

COST's recommended apportionment methodology is consistent with the Multistate Tax Commission's (MTC) 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."[5] We urge the Division to change its position in future regulatory guidance to reflect the fair and constitutional requirement that a taxpayer be allowed to include the factors (e.g., the foreign gross receipts of the CFCs) that produced the GILTI amounts in the denominator of the receipts factor.

That being said, if New Jersey decides to maintain its current approach as set forth in TB-92 and only allows the net amount of GILTI to be included in the denominator of the receipts factor it should still make a change to clarify an ambiguity in TB-92. In that Bulletin, the Division states that "To compute the New Jersey allocation factor on Schedule J, the net amount of GILTI . . . [is] included in the numerator (if applicable) and the denominator." We believe the phrase "numerator (if applicable) and the" should be omitted from future guidance. GILTI, by definition, represents a portion of foreign source income earned by controlled foreign subsidiaries (CFCs) of New Jersey taxpayers. As such, the net amount of GILTI is only properly includible in the denominator, and by definition not in the numerator of the receipts factor.

Indeed, the Division recognized this issue when it released "Clarification Regarding Technical Bulletin TB-92" on August 26, 2019. In that "Clarification," it stated "Second, while the Division is not aware of any specific situation that would require GILTI or FDII related amounts to be included in the numerator of the apportionment factor, we are also not certain that no such situations exist; hence the use of the term 'if applicable' in the TB." To avoid confusion on this issue, COST requests that the Division omit the reference to the "numerator (if applicable)" from future guidance so it is clear the net GILTI amounts are included only in the denominator of the receipts factor.[6]

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

COST would also like to comment on the appropriate apportionment methodology to use with foreign derived intangible income (FDII). In TB-92, the Division reversed its earlier position (from TB-85(R)) on utilizing the GDP methodology for apportioning FDII (as well as GILTI) and instead stated that FDII should be apportioned by including the "net FDII income amounts" in the numerator (if applicable) and the denominator of the receipts factor. Once again, COST commends the Division for responding to the concerns of corporate taxpayers that criticized the GDP methodology as irrational and distortive for apportioning FDII.

However, the new proposed methodology fails to address the essence of FDII—that it is not a new category of income and requires no special apportionment methodology at all. FDII is simply a new federal deduction (that New Jersey has conformed to) that provides a tax reduction

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[5] Multistate Tax Commission, "Proposed Model Statute for Combined Reporting," as amended by MTC section 5(A)(i), (July 29, 2011).
[6] The Division should also strike the reference in TB-92 to sourcing GILTI (and FDII) under the category of "all other business receipts."

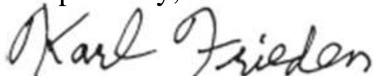
for income from foreign sales of goods and services derived from domestic production and intangible assets held in the United States. As such, all the relevant income and apportionment factors are already included in a taxpayer's New Jersey corporate income tax return, and there is no need to provide a special formula for allocating FDII. Specifically, in future guidance, the Division should omit any reference to including net FDII income amounts in the numerator (if applicable) and the denominator of the receipts factor. This is because the relevant gross receipts from the foreign sales are already (and appropriately) included in the denominator of the receipts factor under New Jersey's existing corporate apportionment rules.

Once again, the Division recognized this issue when it released the "Clarification Regarding Technical Bulletin TB-92" on August 26, 2019. In that "Clarification," the Division stated, "First, while FDII has been newly identified under the IRC as a special category of income, the Division recognizes that the income already existed for both Federal and New Jersey tax purposes. Our intent is that FDII continue to be classified, sourced and apportioned as appropriate under existing NJ statutes and regulations." The Division can effectuate that clarification by making it clear in any future regulatory guidance that existing apportionment rules already work for purposes of apportioning FDII, and no new rules are necessary.

Conclusion

For the reasons outlined above, COST urges the Division to revise the approach taken in TB-92 for apportioning both GILTI and FDII. In the case of GILTI, the Division should allow a taxpayer to include the underlying gross receipts from the CFCs that produced the GILTI amounts in the denominator of the receipts factor. In the case of FDII, the Division should not adopt any special apportionment rules for FDII and instead allow the taxpayer to utilize existing New Jersey sourcing rules to determine which receipts are included in the denominator of the receipts factor. Please contact me with any questions regarding COST's analysis of the New Jersey methodology and recommendations for how the state should apportion GILTI and FDII.

Respectfully,



Karl A. Frieden

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

Comments on Technical Bulletin 92

Allocation of Foreign-Derived Intangible Income ("FDII")

- **FDII is not a new category of income.** Simply stated, FDII is income from sales of goods and services outside of the US that are attributable to US-based intangible assets. These are real sales of the US company. FDII is not a new or fictitious category of income created by the TCJA. All the TCJA did was create a deduction based on these foreign sales by US companies to incentivize such companies to keep their intangible assets in the US.

- **The net FDII amount should not be included in the New Jersey allocation factor because the gross receipts from the foreign sales on which FDII is based are already included.** The guidance provides that FDII, net of the federal FDII deduction, must be included in the computation of the New Jersey allocation factor. Again, FDII is computed based on foreign sales that are already, and have always been, included in the computation of the New Jersey allocation factor and sourced under New Jersey's sourcing rules. It is unclear whether the Division intends to include both the net FDII amount and the underlying receipts in the allocation factor or to include the net FDII amount in lieu of the underlying receipts, but both would be flawed:
  - If both the net FDII amount and the underlying receipts are included, the foreign sales would be overrepresented in the factor.
  - If only the net FDII amount is included and the underlying receipts are required to be removed from the allocation factor, the Division's guidance is inconsistent with the New Jersey statute which provides that "receipts" (not income) must be included in the computation of the allocation factor. N.J. Rev. Stat. § 54:10A-6. Furthermore, including only the net income (net of a federal deduction) from these foreign sales in the allocation factor when domestic sales are included on a gross basis blatantly violates the foreign commerce clause of the US Constitution.

- **The net FDII amount should not be sourced to New Jersey as "other business receipts."** While we do not believe this was the intention of the Division, sourcing FDII as "other business receipts" could result in all of FDII being included in the numerator of the apportionment formula for New Jersey-based companies pursuant to N.J. Admin. Code 18:7-8.12. This would significantly harm New Jersey-based companies. Furthermore, this sourcing methodology would also violate the foreign commerce clause as domestic sales are sourced using a market-based approach.

Proposed Resolution:

- **Do not adopt special apportionment rules for FDII.** Since before the TCJA, the receipts underlying FDII have been included in the New Jersey allocation factor and have been sourced to New Jersey as sales of goods and services under the New Jersey sourcing rules. There is no need to provide a different or new sourcing regime for FDII as FDII is in no way a new category of income. As discussed above, substituting the net FDII amount for the amount of underlying receipts in the allocation factor would be a violation of the commerce clause and inconsistent with the New Jersey statute.

Global Intangible Low-Taxed Income ("GILTI")

- **More than the GILTI, net of the GILTI deduction, should be included in the allocation factor.** The Division's recent guidance provides that GILTI, net of the federal GILTI deduction, must be included in the computation of the New Jersey allocation factor.[1] However, since GILTI is not considered a dividend in New Jersey, it must be income that is considered earned by the US taxpayer and, thus, the receipts underlying GILTI must be attributed to the US taxpayer and included in the receipts factor. It would be a violation of the foreign commerce clause to include only the income (net of a federal deduction) from sales from a foreign business in the allocation factor when domestic sales are included on a gross basis.

- **The net GILTI amount should not be sourced to New Jersey as "other business receipts."** While we do not believe this was the intention of the Division, sourcing GILTI as "other business receipts" could result in all of GILTI being included in the numerator of the allocation factor for New Jersey-based companies pursuant to N.J. Admin. Code 18:7-8.12. This would significantly harm New Jersey based companies.

- **If the CFCs generating GILTI are included in a combined New Jersey return with the taxpayer, their receipts should not be included in the allocation factor on a net basis.** If the CFCs generating the GILTI are included in a combined return with the taxpayer, it would be entirely inappropriate to require the CFCs to include their receipts on a net basis (net of a federal deduction) when all other members of the group include their receipts on a gross basis. This would be a blatant violation of the foreign commerce clause.

Proposed Resolution:

- **The receipts underlying GILTI should be included in the allocation factor.** At the very least, the Division should allow the entire GILTI amount (without the GILTI deduction) to be included in the allocation factor denominator as no other income is included in the factor net of related federal deductions.

- To the extent that GILTI, as opposed to the underlying receipts, is included in the computation of the allocation factor, **the Division should issue guidance providing that GILTI is included in the denominator of the apportionment factor only because GILTI is income earned in a foreign trade or business** (not in New Jersey). *See*, *e.g.,* N.Y. Tax Law § 210-A ("For New York S corporations, global intangible low-taxed income shall not be included in the numerator of the apportionment fraction. Global intangible low-taxed income shall be included in the denominator of the apportionment fraction.").

[1] This guidance applies when the CFCs generating GILTI are not included in the combined NJ return.