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## Should States Embrace GILTI?: A Cost-Benefit Approach

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## Should States Embrace GILTI?

by Jeanne Rauch-Zender

Congress inserted several provisions into the Tax Cuts and Jobs Act, arguably intended to address corporate arrangements when federal taxable income on which the states rely is disconnected from profitability, perhaps most significantly a tax on global intangible low-taxed income. In this installment of Board Briefs, I asked *State Tax Notes* board members to weigh in on whether states should embrace GILTI.

This article is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

### A Cost-Benefit Approach



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In the venerable tradition of answering a question by asking a question, I would answer the question, "Should states embrace global intangible low-taxed income?" by asking: "Are the costs worth the benefits?" To avoid unreasonable expectations regarding the scope and objective of my proposed cost-benefit inquiry, I begin with some caveats. First, the inquiry does not consider the merits of taxing GILTI as a matter of national tax policy, but simply takes the federal corporate income tax base as a given to which states generally conform. Second, the inquiry assumes that raising revenue is a benefit. Although one may take issue with that assumption because every dollar of

"benefit" is a dollar of "cost" to taxpayers, the inquiry proceeds from the premise that the "civilized society" for which "taxes . . . pay" is a net benefit.<sup>1</sup> Third, the inquiry does not yield an unequivocal answer that will command universal support. Instead, my more modest objective is simply to provide a framework within which the inquiry might proceed with the hope that it will advance meaningful discussion and enhance the probability of resolving the question of whether states should embrace GILTI in a sensible manner.

The benefits of embracing GILTI are fairly obvious. First, it brings with it the benefits of conformity: namely, easing compliance and auditing burdens, which has been the prime force responsible for the very wide conformity of the state corporate income tax base to federal corporate income tax base.<sup>2</sup> Second, as I have already suggested, or, more precisely, assumed, embracing GILTI provides a benefit by enhancing state revenues and helping to "pay for civilized society." It is difficult to overstate the value of that benefit.

What are the costs of embracing GILTI that need to be weighed against these benefits? Although a detailed answer to this question cannot be provided within the confines of a Board Briefs contribution,<sup>3</sup> the ensuing discussion seeks to identify the principal costs associated with states' embrace of GILTI. First, the presumed benefits of conformity may well be outweighed by the costs of conformity, at least from an administrative perspective. In other words, there is less than meets the eye to the benefits of

<sup>1</sup> *Compañia General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) ("Taxes are what we pay for civilized society.").

<sup>2</sup> See Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para. 7.02 (3d ed. 2018 Rev.).

<sup>3</sup> For a more expanded analysis of this question, see Walter Hellerstein and Jon Sedon, "State Corporate Income Tax Consequences of Federal Tax Reform," *State Tax Notes*, Apr. 16, 2018, p. 187; and Hellerstein, *State Taxation*, *supra* note 2, para 7.16A[2]. The following discussion draws freely from these sources.

conformity when one is talking about GILTI. New IRC section 951A, which effectively defines GILTI, appears in subpart F, and in substance treats GILTI as a deemed dividend received from a controlled foreign corporation under subpart F. Nevertheless, GILTI is not technically subpart F income as defined by the IRC. Indeed, the definition of GILTI — the U.S. shareholder's "net CFC tested income for such taxable year" over the shareholder's "net deemed tangible income return for such taxable year"<sup>4</sup> — explicitly excludes from the net CFC tested income, "any gross income taken into account in determining the subpart F income of such corporation."<sup>5</sup> Yet for purposes of other IRC provisions, GILTI is "treated in the same manner as an amount included" under subpart F.<sup>6</sup>

What may appear superficially to be fine semantic distinctions regarding the characterization of GILTI for federal income tax purposes has significant implications for purposes of the states' treatment of GILTI under their conformity provisions. Most states do not conform to subpart F.<sup>7</sup> However, as noted above, the IRC explicitly excludes GILTI from the definition of subpart F income, although section 951A (the provision subjecting GILTI to tax) falls squarely within subpart F. How states will construe these technical distinctions between subpart F income and income subject to tax under subpart F raises technical questions of extraordinary complexity (especially to state tax administrators not schooled in the details of subpart F and the Tax Cuts and Jobs Act), and significantly undercuts the argument that state conformity to the IRC constitutes an administrative benefit rather than an administrative cost.

Similar questions can and no doubt will be raised about the 50 percent deduction for U.S. shareholders that are subject to tax on GILTI. Will states that conform to the inclusionary provision likewise conform to the federal deduction, which falls within the part of the IRC listing "Special Deductions for Corporations"? Will the answer to this question depend on whether a state conforms to

federal taxable income before net operating loss and special deductions (line 28 of the most recent version of federal Form 1120) or federal taxable income after NOLs and special deductions (line 30 of the most recent version of Form 1120)?

Wholly apart from the costs associated with statutory issues raised by embracing GILTI, there is a host of thorny constitutional issues raised by the inclusion of GILTI in the states' corporate tax base. For example, if a state determines as a matter of statutory construction that it conforms to the GILTI inclusion, but not to the GILTI deduction, would that frustrate federal policy in violation of the supremacy clause? Even if including GILTI in the tax base raises no supremacy clause issues, does GILTI constitute constitutionally apportionable income in the U.S. shareholder's apportionable tax base under the commerce and due process clauses? Assuming the U.S. shareholder is not domiciled in the taxing state, the answer to this question will depend on whether the U.S. shareholder is engaged in a unitary business with its CFC or whether the CFC is serving an "operational function" in the U.S. shareholder's business. Assuming that GILTI is constitutionally includable in the U.S. shareholder's apportionable tax base, questions may then arise regarding the fairness of the apportionment of that income from a constitutional standpoint, including whether the CFC's factors should be included in the U.S. shareholder's apportionment formula and, if so, on what basis. Furthermore, in addition to questions of apportionability and fair apportionment, there is the question of whether the state's taxation of GILTI discriminates against foreign commerce by taxing income of CFCs that would not be taxed if earned by equivalent controlled domestic corporations. As anyone who is still reading this Board Brief is well aware, answering the foregoing questions can involve long, complex, and expensive inquiries with uncertain outcomes.

As noted at the outset of this brief, my proposed cost-benefit analysis promised no definitive answer to the question whether states should embrace GILTI. My principal objective was to suggest the apparent benefits of conformity and increased revenue that may well be offset by the costs of conformity, and controversies over the inclusion that could well lead to the conclusion that inclusion of GILTI is not worth the candle.

<sup>4</sup> Section 951A(b).

<sup>5</sup> Section 951A(c)(2)(A)(i)(II).

<sup>6</sup> Section 951A(f).

<sup>7</sup> See sources cited *supra* note 3 indicating that only about one quarter of the states with corporate income taxes include federal subpart F income in their provisions conforming to the federal tax base.