Why (and How) States Should Tax the Repatriation

David Gamage  
*Indiana University Maurer School of Law, dgamage@indiana.edu*

Darien Shanske  
*University of California, Davis*

Follow this and additional works at: [https://www.repository.law.indiana.edu/facpub](https://www.repository.law.indiana.edu/facpub)

Part of the Taxation-Federal Commons, and the Taxation-State and Local Commons

**Recommended Citation**

[https://www.repository.law.indiana.edu/facpub/2685](https://www.repository.law.indiana.edu/facpub/2685)

This Article is brought to you for free and open access by the Faculty Scholarship at Digital Repository @ Maurer Law. It has been accepted for inclusion in Articles by Maurer Faculty by an authorized administrator of Digital Repository @ Maurer Law. For more information, please contact rvaughan@indiana.edu.
Why (and How) States Should Tax the Repatriation

by Darien Shanske and David Gamage

Darien Shanske is a professor at the University of California, Davis, School of Law (King Hall), and David Gamage is a professor of law at Indiana University Maurer School of Law.

In this edition of Academic Perspectives on SALT, the authors discuss how states should treat income earned by the foreign subsidiaries of U.S. corporations.

Readers of State Tax Notes know that a lot of income earned by the foreign subsidiaries of U.S. corporations is coming home — or rather is being deemed to be coming home under new IRC section 965. There has accordingly been a lot of analysis of how the tax laws of the various states will treat this returning income. In this essay, we take a step back and consider how state tax laws should treat this income. We then analyze the federal constitutional ground rules on taxing this income. We conclude that federal constitutional law permits states to tax the repatriated income in the manner we recommend based on our policy analysis.

Introduction: What Is the Repatriation?

The old U.S. international tax regime permitted multinational firms to defer payment of tax on most of the income they earned overseas — defer until the firm brought the money home. So, for instance, until Apple Germany sent home its profits to Apple U.S., those profits would not be subject to tax. Naturally, Apple and other multinationals let a lot of income hang out abroad — an estimated $2.6 trillion in 2015.

To get this money to come home, a strategy used in 2004 was to offer a special low rate. “Repatriate now and pay 5.25 percent rather than the usual 35 percent rate” was the 2004 deal. The tax law just passed applies stronger medicine. The new law deems all the income held offshore to be repatriated and then applies a tax rate of either 8 percent or 15.5 percent.

The Joint Committee on Taxation estimates that this provision will raise $338 billion over 10 years. To return to Apple, this one company alone expects to pay $38 billion on its $252 billion of repatriated earnings.


2. Letter to Honorable Kevin Brady, Joint Committee on Taxation, Aug. 31, 2016.

3. For critical discussion of the 2004 holiday, see Chuck Marr and Chye-Ching Huang, “Repatriation Tax Holiday Would Lose Revenue and Is a Proven Policy Failure,” Center on Budget and Policy Priorities (June 2014). Note that the authors are much less critical about a one-time transition tax spent on one-time needs such as infrastructure.

4. IRC section 965.


Policy: Why States Should Tax the Repatriation

We can identify at least four broad reasons why a state should tax the repatriation. These reasons are not mutually exclusive.

(1) These Earnings Are Partially Domestic

There is overwhelming evidence that at least a substantial portion of the earnings parked abroad were, in fact, earned in the United States and should always have been part of the domestic corporate tax base. For instance, consider the curious fact that there are a number of jurisdictions in which the reported profits of U.S. controlled subsidiaries represent multiples of the gross domestic product of the entire jurisdiction. To take one fun example, the profits of U.S. controlled subsidiaries in the Cayman Islands represented over 1,000 percent of that island’s GDP in 2014. We also have a pretty good idea what kinds of planning structures were used to create these results. These first two clues fit together, as on the one hand we know about the planning structure known as the “double Irish Dutch sandwich,” and we know as well that both the Netherlands and Ireland are home to enormous amounts of the profits of U.S. controlled subsidiaries relative to those countries’ GDPs. Also of note is the long-term decline of the productivity of the corporate tax relative to corporate profits. Accordingly, a leading commentator concludes: “While the magnitude of corporate profit shifting by U.S. multinationals into low or no tax countries is uncertain, there is overwhelming evidence of its existence and its increase in recent years.”

The JCT has estimated the 2017 cost of deferral to the U.S. fisc at $119 billion. Working backward from that estimate and assuming that the avoided federal rate was 35 percent, the JCT thinks that, in 2017 alone, $340 billion in U.S. corporate profits did not come home. Some substantial portion of that $340 billion was earned in the United States.

(2) Ability-to-Pay Principle

A corporation repatriating $252 billion to the United States is better off than a corporation, with similar domestic income, that is not repatriating $252 billion. Because this is so, and, to the extent that we have a corporate income tax in order to apply the ability-to-pay principle to corporations, the repatriated earnings should be reflected in a corporation’s tax base.

To elaborate, although the incidence of all taxes ultimately falls on people, corporations nevertheless represent important nexuses of economic activity. All else being equal, large repatriations indicate greater economic activity within a particular corporate nexus that should be subject to tax.

(3) Progressive Taxation of Immobile Base

In general, tax policymakers must contend with the fact that the most progressive tax bases are usually the most mobile and therefore are less efficient to tax. This is the textbook “equity-efficiency” trade-off. The problem of interjurisdictional mobility is especially pressing for states within the free trade area of the United States. But the deemed repatriation makes the most mobile of capital immobile — it must return and indeed it already has. Businesses cannot now move out of state to avoid the tax on the repatriation. Thus taxing the repatriation is efficient because the base is immobile, and it is progressive because some significant portion of the repatriation is going to enrich wealthier citizens.

13 Here is a cite to a textbook: Jonathan Gruber, Public Finance and Public Policy 6-7, 597-600 (4th Ed. 2013).
(4) Recouping a National Loss

One way to conceive of the huge pool of earnings that accumulated abroad through a quirk of the U.S. international tax system is that it represented a form of forced national savings. Say the $2.6 trillion had been deemed returned and taxed at 35 percent. This would have yielded $910 billion that could then have gone a long way toward funding any number of national priorities. For instance, that money could have been spent on infrastructure or, better still, capitalizing a national infrastructure bank to create a large and permanent source of funding. The new tax law deviated from this sensible prescription in two ways. First, the new law subjected the repatriation to only a low tax rate, thereby in a sense squandering more than half its value as accumulated savings. Second, the one-time funds from the repatriation were used as a way to pay for permanent business-level tax cuts. Thus, a state seeking to tax the repatriation and use that one-time money for (say) state infrastructure would in a sense just be recapturing a portion of this squandered national wealth.

Moreover, an additional and related federalism angle is worth noting, one that also goes back to our first rationale. Ultimately, the peculiar, prior federal treatment of corporate income incentivized at least part of the erosion of the state corporate income tax base. This happened for two reasons. First, the federal deferral rule gave corporations an incentive to shift domestic profits abroad. Second, the 2004 federal repatriation holiday and the regular consideration of additional holidays gave corporations still additional incentive to shift their profits abroad. From this perspective, states are not only trying to tax shifted domestic profits, but profits shifted because of flaws in national tax policy.

Constitutional Framework

Our primary concern here is not with how a new tax comports with current state law, but instead with federal constitutional ground rules. Here are the primary relevant federal constitutional ground rules, as we see them.

First, any new tax needs to be fairly apportioned. The Supreme Court has further explained that it is particularly concerned about double taxation to the extent a state tax involves — or might involve — foreign income. That said, the Court has upheld typical state apportionment formulas in this context as appropriately sensitive to foreign dormant commerce concerns, and so a reasonable variation on the kinds of formulas common in the states should likely pass muster.

Another approach to consider is to tax the repatriation net of foreign taxes, especially as the foreign taxes imposed are in many cases not likely to be significant.

Second, any new tax cannot discriminate against — or favor — foreign commerce. So, for instance, if a state opted to tax the repatriation at a higher rate than its ordinary corporate income tax, this would appear like the state is taxing foreign income at a higher rate. Arguably, just taxing the repatriation creates a problem if one conceives of the transition tax as falling on foreign subsidiaries but not domestic subsidiaries. But this is not the right conception if we are only trying to tax domestic income. If the income in question had been earned by a domestic subsidiary, it would have been taxed — and a long time ago — and thus there is no discrimination.

Given the sums of money involved, simply applying a state’s ordinary rate should yield quite a lot of income, but can a state impose a higher tax

---

18 Id. at 170-71.
19 Id. at 193.
20 IRC section 965(g) actually limits the amount of the tax credit available against the repatriated earnings to take into account the reduced rate of tax applied to these earnings. Given that a state should tax these earnings in full, a state should grant the full credits, if that is the approach taken.
21 Kraft General Foods Inc. v. Iowa Departmnet of Revenue and Finance, 505 U.S. 71 (1992). Note that the Kraft decision is not analytically sound given that domestic and foreign subsidiaries are differently situated, see Wetzler supra note 11, but passing a law that requires the Supreme Court to overturn Kraft is not a best first choice.
22 See Friedman et al. supra note 1.
on the repatriated earnings? Again, we think so if a state takes the position that it is not taxing foreign income but domestic income. We have already seen that any state has an overwhelming prima facie case that this is so; all those profits residing in the Cayman Islands were not earned there. As for domestic income, states can surely tax that at different rates, subject to rational basis review. Thus a state could make a reasonable argument that it was taxing the domestic income represented by a share of the repatriation at a higher rate because this higher rate is meant as a deterrent for future aggressive tax planning or compensation for the time value of money and other problems caused by the deferral.

A third important point here is that the burden on a taxpayer challenging an apportionment formula is very heavy: the taxpayer must “prove by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted in that State.” Thus, the burden is not on a state to come up with the best possible estimate of what percentage of the repatriation was really earned in the United States. Rather, it will be the burden of the taxpayer to show that the state’s reasonable efforts clearly fail.

Fourth, there is the unitary principle. New IRC section 965 creates more subpart F income for some foreign corporations. A state cannot assert that a part of this income is part of the income of a U.S. corporation unless those two firms constitute a unitary business. This is true whether a state is a combined reporting state or a separate reporting state.

Fifth, states need to attend to the past. Any state tax on the repatriated income needs to include some safety valve in the (unlikely) scenario that some portion of that income has been taxed already. For instance, suppose a state requires worldwide combination, and a corporation did not make a water’s-edge election; in that case, the income earned by a foreign corporation that is part of the unitary group has been taxed.

Sixth, states need to attend to the possibility of nonbusiness income. Some of the repatriated income might arguably represent investment income. In such a scenario, the income cannot be apportioned, but must be allocated.

Seventh, the states cannot mix and match tax principles. Consider California. As a large-market state that uses single-sales-factor apportionment, California is in a strong position to tax a sizable percentage of the repatriation as earned within California. If California does so tax the repatriation, it would be doing so according to the source principle. But California has another attractive option. Many of the big corporations that earned this foreign income are domiciled in California — think Apple, Google, Facebook, etc. California could instead tax on the basis of the residence principle. That is, California can tax all of Apple’s repatriated income, subject to foreign tax credits. Of course, if California went this route, it would tax Microsoft’s share of the repatriation very little, as it is not domiciled in California. It would be nice for California to be able to tax Apple based on residence and Microsoft based on source, but that is a clear violation of internal consistency. California must choose; except for California and maybe New York, the preference on revenue grounds should presumably be for the source principle. More importantly, the source principle is already at the heart of all state corporate income tax systems.

Eighth, states should act with sensitivity to retroactivity (due process) and contract clause issues. The deemed repatriation happened last year, and last year there were state law rules about how subpart F income was to be treated. Any new law will therefore raise retroactivity concerns; it

---

23 We are not saying that a state could not choose to tax the repatriation as foreign income, just noting that this approach creates greater doctrinal complexity — complexity that a state need not engage with.


25 Container, 463 U.S. at 170 (internal citations omitted).


27 A separate reporting state would have to enact a different statute so as to deem the repatriated income as income stripped out of corporations within the state. For some ideas about structures, see Mark J. Cowan and Kathy Hurley, “Receding Water’s Edge: State Efforts to Tax Corporations’ Foreign Tax Haven Income,” State Tax Notes, Nov. 2, 2015, p. 403.

28 See Wright, supra note 1.

29 Allied Signal, at 504 U.S. at 787-88.

will also raise objections to the extent it changes some aspect of a state’s earlier treatment of subpart F income. The limited U.S. Supreme Court case law on such matters gives the states a lot of leeway, as seems correct to us given the policy exigencies that states must cope with. Recent cases that have attracted a lot of attention in State Tax Notes indicate that state supreme courts have followed the high court’s lead; we are thinking of the various cases involving the apportionment election under the Multistate Tax Compact and also Dot Foods v. Washington Department of Revenue.\textsuperscript{32}

Even if one grants that some of the recent disputes have represented hard cases (and we do so grant, though we think these cases correctly decided), a well-crafted tax on repatriation should be a much easier case. The federal tax law made very significant changes to the federal tax system in December 2017; it cannot be a violation of due process or the contract clause if a state makes reasonable alterations to its tax system in response within a reasonable time. Note the double “reasonable” here. As to timing, states need to move expeditiously. There is no fixed rule, but the longer the states take to act, the stronger the retroactivity challenge. As to other changes, the states are on the strongest ground when they make retroactive changes to specifically cope with changes that the federal tax law made last year — in this case new IRC section 965. Using a retroactive bill on repatriation also to deal with other aspects of state taxation not affected by the federal law would weaken the states’ case.

**Tax Design**

Our long discussion of principles allows us to conclude with a much shorter discussion of the design of the tax. There is more than one possible approach, but we conclude with a sketch of one possible approach in order to be helpful.

Remember, one of our recommendations is to move expeditiously. Here are some features that we would recommend for a new tax.

The design should make it clear that the purpose in levying the tax is to reach repatriated earnings to the maximum extent permitted by the federal Constitution and that any income not apportionable should be subject to allocation.

The tax should be accompanied by findings that a significant source of the repatriation income was earned within the United States. We think a reasonable starting point for a percentage of the repatriation earned in the United States would be 35 percent, which was the percentage of U.S. GDP to that of the OECD in 2013.\textsuperscript{34} This is a conservative estimate for many reasons, including that many OECD countries (for example, the Netherlands) were also tax havens, but we think this is a reasonable place to start. Taking the $2.6 trillion figure, this means that $910 million of the repatriated income was earned domestically. Given the large number of years over which the repatriated earnings were earned, we think states should consider a very simple apportionment formula, such as state GDP to national GDP or state population to national population.

We think it appropriate to give corporations an opportunity to challenge the resulting apportionment of income. In most cases, it is hard to imagine a taxpayer carrying its burden, but there will be some cases for which we can imagine that a taxpayer will be able to show that for state tax purposes some income has already been taxed.

Then there is the question of the rate. We think a high rate would be appropriate, say the state’s regular corporate income tax rate plus 10 percent. Because this new tax is going to be imposed on a type of domestic income, then the state legislature should prepare findings to explain why this higher rate is reasonable. This should not be hard to do. These domestic earnings were stripped out of the state’s tax base by means of aggressive tax planning, and states are entitled to discourage such planning. Furthermore, the ability to engage in such tax planning is not evenly distributed and so the success of this planning placed the burden

\textsuperscript{31}United States v. Carlton, 512 U.S. 26, 31, 33 (1994) (“Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. … Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code.” (internal citations omitted)).

\textsuperscript{32}See, e.g., Gillette v. Department of Treasury, 878 N.W.2d 891 (2015), cert. denied 132 S. Ct. 2157.

\textsuperscript{33}72 P.3d 747 (2016) (en banc), cert. denied 237 S. Ct. 2156.

\textsuperscript{34}“Gross National Income,” OECD (undated).
on other taxpayers inequitably. Or, if the state could not shift the tax burden to less aggressive taxpayers or those with less flexible business models, then pressing state priorities, such as infrastructure, were deferred because of the loss of revenue. Catching up on poorly maintained infrastructure is more expensive, for example, than doing it right the first time. Finally, taxing a less elastic tax base is the height of (tax) rationality.\textsuperscript{36} States in effect reduce their tax rates very substantially to attract less mobile capital;\textsuperscript{36} this would simply be an example of applying that concept in reverse.

The new law should contain a severability clause lest any provision, such as the higher rate, be found unconstitutional.\textsuperscript{37}

**Conclusion**

In coming columns, we will have a lot to say about various other aspects of the changes wrought by the new federal law. The repatriation represents low-hanging fruit, but it is fruit that needs to be picked sooner rather than later — and with care.

\textsuperscript{35} Gruber, \textit{supra} note 14, at 592-93.


\textsuperscript{37} Another complexity could be required if a court required inclusion of the foreign factors. Courts have not so required in similar cases to date. See Friedman et al. \textit{supra} note 1. Furthermore, and crucially, this tax is aimed at domestic income. Along with a severability clause, states might nevertheless consider a backup formula for inclusion of the foreign factors, perhaps a ratio roughly modeled on California’s Cal. Rev. and Tax Code section 25110(a)(2)(Â)(ii).