2019

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Recommended Citation

Gamage, David and Shanske, Darien, "Why States Can Tax the GILTI" (2019). *Articles by Maurer Faculty*. 2745.

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Why States Can Tax the GILTI

by Darien Shanske and David Gamage

The most critical weakness of the modern corporate income tax is its vulnerability to profit shifting, through which corporate taxpayers can engage in tax planning to report profits in foreign tax havens or low-tax jurisdictions. The sweeping 2017 federal tax legislation made three changes that dramatically affect this problem: (1) The federal corporate tax rate was reduced from 35 percent to 21 percent; (2) the corporate tax base was switched from being based on the worldwide income of U.S. corporate taxpayers to a territorial system in which corporate taxpayers’ foreign income is potentially exempt from tax; and (3) new antiabuse rules were implemented to combat profit shifting, perhaps the most important of which is the global intangible low-taxed income regime.

GILTI is a new federal tax provision that seeks to identify income displaced out of the United States by ascertaining whether it was the product of an unusually high rate of return. An unusually high rate of return is interpreted as a proxy indicating that the income in question was actually earned somewhere other than where it was reported.

We have already argued that states should conform to GILTI. But might there be constitutional restrictions preventing states from doing so? In this article, we argue that state governments can constitutionally conform to the federal GILTI rules and thereby tax GILTI income as part of the states’ corporate income tax bases. However, in doing so, we explain that state governments will need to be attentive to background constitutional principles.

A state is permitted to use a reasonable formula to approximate how much of a multijurisdictional enterprise’s income can be fairly apportioned to the state. The burden on the taxpayer challenging the formula is then heavy, as it 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.”

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² See Darien Shanske and David Gamage, “Why States Should Tax the GILTI,” State Tax Notes, Mar. 4, 2019, p. 751. Our conclusions are substantively similar to the excellent analyses of Walter Hellerstein and Jon Sedon, “State Corporate Income Tax Consequences of Federal Tax Reform,” State Tax Notes, Apr. 16, 2018, p. 187; and Lee A. Sheppard, “Is Taxing GILTI Constitutional?” State Tax Notes, July 30, 2018, p. 439. Our column is focused on objections to taxing GILTI that have emerged since these two articles were written; we also delve further into the details of how states can tax GILTI.

In deciding how much income of a conglomerate enterprise a state can subject to its formula, the state is limited by the unitary business principle. Under the unitary business principle, states may include the (operational) income nominally earned abroad in their formula approximations as long as the foreign businesses are engaged in a unitary business. Spokespeople for business taxpayers and their allies sometimes speak of mandatory worldwide combination (and of GILTI conformity) as if they were designed to tax foreign income. But this is inaccurate. Instead, what these provisions do is to look to income nominally earned elsewhere to arrive at a more accurate estimate of income earned in a state.

Up to this point, analysis of GILTI inclusion (as well as the repatriation) is rather straightforward. The primary challenge is constructing a reasonable formula. After all, even if all GILTI income has been shifted out of some other jurisdiction, not necessarily all of that income has been shifted out of the United States. This raises the question of factor representation, which we will address below. One thing to note is that the basic constitutional rules of apportionment do not dictate how foreign factors are to be represented, as long as the approach is reasonable. Thus, because the whole purpose of GILTI’s calculation rules is to ferret out income not produced by the foreign assets that the taxpayer claims is responsible for them, the foreign income that GILTI identifies through these calculations should not be treated the same as other foreign income. Accordingly, the states should be permitted to use a formula other than their standard formula for non-GILTI foreign income to reasonably determine how much of this income should be apportioned to the state.

The U.S. Supreme Court has applied these background principles to arrive at what is effectively the same conclusion in a similar context. Consider the facts in Hunt-Wesson v. Franchise Tax Board. In that case, the Court struck down a California rule that ascribed all interest expense first to non-unitary businesses. The Court held that this rule went too far. Nevertheless, the Court understood that California had enacted the rule to counter the difficulty of ascertaining whether an interest expense was actually undertaken to reduce income of a California business that would otherwise be taxable by the state. Thus, the Court went out of its way to bless “ratio-based rules” used by the states and the federal government in this (interest) context and other similar contexts.

As applied to the GILTI question, it seems clear that if a ratio-based rule can be used to disentangle suspect expenses, such a rule should also be permitted for disentangling suspect income, including GILTI income.

**Kraft v. Iowa, Take 1**

Some believe that under *Kraft v. Iowa,* states cannot conform to GILTI at all — or, if they can, that they can only do so by using an apportionment formula that treats GILTI the same as the income produced by domestic subsidiaries. *Kraft* is not actually about apportionment. The state in *Kraft,* Iowa, was a separate reporting state. Following the federal definition of taxable income, Iowa taxed dividends received from foreign subsidiaries, but not dividends derived from domestic subsidiaries. Despite several arguments in favor of the Iowa structure, including administrative convenience and that this structure does not necessarily have any discriminatory impact, the Court struck down the law as facially discriminatory against foreign commerce.

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6. Indeed, the very title of the Tax Foundation report on GILTI is inaccurate on this score. Jared Walczak, “GILTI Minds: Why Some States Want to Tax International Income — And Why They Shouldn’t,” Tax Foundation (Jan. 28, 2019).
7. As explained in a prior article, we believe that it is not too late for states to do the right thing and tax the repatriation. See Shanske and Gamage, “Why (and How) States Should Tax the Repatriation,” *State Tax Notes,* Apr. 23, 2018, p. 317.
10. The Iowa structure clearly did not advantage Iowa businesses. In general, *Kraft* is not a compelling decision, and the dissent by Chief Justice William H. Rehnquist (joined by Justice Harry Blackmun) seems to get the better of the argument.
Some leading commentators have argued that Kraft established a rule that a state cannot treat foreign-source income less favorably than domestic-source income.\(^{11}\) Applied to the GILTI question, commentators have argued that GILTI is foreign-source income and, as such, must be apportioned just like domestic-source income, or else this would result in impermissible discrimination under Kraft.\(^{12}\)

However, even before analyzing Kraft further, this is a surprisingly prescriptive conclusion, and one that runs against the mass of precedent that gives states considerable leeway in taxing multijurisdictional enterprises — leeway that makes sense given the respect the states are due as sovereigns trying to exercise a core function of revenue-raising.\(^{13}\)

Moreover, there are multiple flaws with this argument as an interpretation of what Kraft demands regarding GILTI income. First, the statute in question in Kraft was based on a simple binary — the income in question would either be subject to tax or exempt. There was thus no discussion in Kraft of whether having a different apportionment formula for foreign-source income would be permissible. As we have already explained, the general constitutional rules governing fair apportionment grant the states considerable leeway in designing their formulas. So if states can apportion the income of financial services companies differently and can add back suspicious deductions\(^ {14}\) or have special water’s-edge rules for income earned in tax havens — none of which has been deemed constitutionally problematic — it then seems clear that Kraft should not bar states from applying some special formula for GILTI income, as long as that formula uses a reasonable method for approximating how much of that income should be apportioned to the state.

Second, the Court in Kraft emphasized that it was treating the dividends at issue in Kraft as foreign-sourced: “The only subsidiary dividend payments taxed by Iowa are those reflecting the foreign business activity of foreign subsidiaries.”\(^ {15}\) The Court did not reach the question whether it would be constitutional for a state to treat some portion of nominally foreign earnings as actually earned domestically. Again, general constitutional principles and the holdings of Container and Barclays indicate that states are entitled to use nominally foreign income as a reference point in their calculations. Furthermore, Hunt-Wesson answers the analogous question about deductions clearly: States can use a reasonable ratio-based rule to apportion deductions that the state has good reason to believe are misreported.

**Kraft v. Iowa, Take 2 — Factor Representation**

To summarize our argument so far: States can conform to GILTI and, in doing so, can use any reasonable formula to disentangle how much GILTI income should be apportioned. Therefore, the states need not — and as a policy matter, should not — use an apportionment formula that assumes, in effect, that GILTI income is true foreign income, because the whole purpose of GILTI is to identify misreported income, a portion of which was actually earned within the United States rather

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\(^{12}\) Id.

\(^{13}\) As the Supreme Court has explained, there is a “strong background principle against federal interference with state taxation.” National Private Truck Council Inc. v. Oklahoma Tax Commission, 515 U.S. 582, 589 (1995).

\(^{14}\) We are focusing our discussion on combined reporting states, as it seems odd for a state concerned with income stripping not to start with domestic income stripping. Nevertheless, contrary to what many claim, we do not think it at all obvious that a separate reporting state cannot conform to GILTI. Separate reporting states can and do have addback statutes to protect their tax base, so we don’t see why they cannot conform to GILTI as a kind of addback statute targeting international income shifting.

\(^{15}\) Kraft, 505 U.S. at 77.
than in the foreign jurisdictions in which it was reported to have been earned.

For example, a state might first use some reasonable formula for estimating what portion of GILTI income was displaced out of the United States and then subject that number to a domestic apportionment formula for assessing how much of that income should be taxed by the state. This is our understanding of how New Jersey has approached GILTI conformity. First, New Jersey uses conformity to the 50 percent deduction given under IRC section 250 to estimate how much income has been stripped out of the U.S. tax base relative to the rest of the world. New Jersey then uses its share of domestic GDP to apportion this estimated amount to the state.

Using an approach like New Jersey’s should be constitutionally permissible. But does this mean we believe that some foreign-factor representation is strictly required? Not necessarily, although we do think that some reasonable explanation of an approach is advisable. In a subsequent article, we plan to address whether a state might permissibly go further than New Jersey and forgo representing foreign factors in the GILTI context.

**Conclusion**

As we argued in our prior article, state governments should conform to GILTI because it is an effective way to broaden their corporate tax bases with relatively little administrative burden. In this article, we explained that it is clearly constitutionally permissible for state governments to conform to GILTI.

In theory, there might be better policy alternatives to simply conforming to GILTI. For instance, states could implement an improved version of GILTI or adopt mandatory worldwide combination. However, these options would all require more effort in terms of design, implementation, and administration. We think ease of practical attainability should win the day — at least in the short term. We urge state governments to incorporate GILTI income in their corporate income tax bases. The goal of preserving the besieged state corporate income tax base requires taking this relatively easy opportunity to broaden it, and this opportunity is one worth taking.

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16 Shanske has consulted with New Jersey on its approach.
17 We do not think that states must offer the 50 percent deduction on federal supremacy grounds. After all, we consider it a close question whether the federal government could explicitly require states to levy corporate income taxes within certain rate bands; see Gamage and Shanske, “The Federal Government’s Power to Restrict State Taxation,” *State Tax Notes*, Aug. 15, 2016, p. 547. By contrast, it is not a close question whether a federal government deduction with no mention of the states can be interpreted to preempt how states structure their taxing authority. Because it is unnecessary that states conform to the IRC section 250 deduction, we observe that conforming to it can be helpful for building a reasonable apportionment method.

18 But why is the 50 percent reasonable? There is evidence that, out of the total income shifted out of higher tax jurisdictions, percentages as high as 42 percent are shifted out of the United States. Clearly, any first cut below 42 percent looks reasonable. A state like New Jersey might reasonably choose to go with a slightly higher estimate because: (1) it recognizes the limits of these estimates and is seeking to be conservative with the public fisc; (2) it recognizes that there will now be more incentive for taxpayers to shift income out of the United States as a result of the federal-level shift away from taxing worldwide income and that the future numbers may be higher; and (3) a relatively high-tax state might reasonably believe that income is slightly more likely to be shifted out of its tax base as compared to the U.S. average. For these reasons, we view New Jersey’s use of 50 percent as a somewhat aggressive, but not unreasonable, estimate for how much income has been stripped out of the U.S. tax base relative to the rest of the world.


19 But is the use of GDP reasonable? We have been surprised that there has been such hyperbole from the private bar to the effect that it is not. See Amy Hamilton, “All the Talk: New Jersey’s Unique Method for Apportioning GILTI,” *State Tax Notes*, Feb. 25, 2019, p. 717. We think it is reasonable for a state that uses the single sales factor to expect that, on balance, sales in the state should track the economic value created in the state. Other approaches, such as using a taxpayer’s apportionment factors without taking GILTI into account, would also be reasonable. A state might opt for the GDP approach on the theory that the ordinary sales factor for a taxpayer with GILTI is already compromised, especially as to GILTI itself. Furthermore, the use of GDP in this context is a defensible presumption because of the availability of alternative apportionment (not to mention not taking the water’s-edge election).

20 Shanske and Gamage, supra note 2.