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Why States Should Tax the GILTI

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state tax notes®

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In this installment of Academic Perspectives on SALT, the authors argue that states should conform to federal tax law and bring global intangible low-taxed income into the state corporate income tax base.

Corporate income taxes are a critical revenue source for both states and the federal government, yet they have been increasingly plagued by taxpayers' use of tax-avoidance mechanisms for shifting profits to tax havens and to other (low-tax) foreign jurisdictions. This is perhaps the central problem of modern corporate tax administration.

The sweeping 2017 federal tax legislation attempted to deal with this problem in a number of ways.[1] First, the federal corporate tax rate was reduced from 35 percent to 21 percent. Second, the corporate tax base was switched from being based on the worldwide income of U.S. corporate taxpayers to a territorial system in which the corporate taxpayers' foreign income is potentially exempt from tax. Third, new antiabuse rules were implemented to combat profit shifting, the most important of which is the global intangible low-taxed income regime.

Without GILTI's anti-profit-shifting rules, the switch to a territorial system for the U.S. corporate tax base would have turbocharged the incentives for taxpayers to engage in widespread profit-shifting tax avoidance transactions. The essence of how the GILTI rules work is by identifying foreign assets that are unusually profitable by means of a formula, then subjecting that income to U.S. tax even though the income is nominally earned abroad.[2]

These federal developments raise the question whether states should conform to federal tax law and bring this GILTI income into the state corporate income tax base. As a matter of tax policy, the answer is clearly yes.[3]

Some Preliminaries

We will discuss how states should approach GILTI on the assumption that the federal formula is, at least in part, successful. This is a reasonable assumption. First, we agree with what we take to be the consensus view that income shifting by multinational corporations is

[1] For discussion, see David Kamin et al., "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation," 103 *Minn. L. Rev.* ___ (forthcoming) at 39-61.

[2] For elaboration, see *id.*; and Daniel Shaviro, "The New Non-Territorial U.S. International Tax System, Part 2," *Tax Notes*, July 9, 2018, p. 171.

[3] We do not write on an empty slate here. For similar analyses that we found helpful, see in particular: Lee A. Sheppard, "Is Taxing GILTI Constitutional?" *State Tax Notes*, July 30, 2018, p. 439; and Michael Mazerov, "Legislators: Don't Feel Guilty About Taxing GILTI" (Nov. 17, 2018).

a substantial — and growing — phenomenon.[4] Second, we agree that absent effective antiabuse rules, the federal move to a territorial system would have dramatically increased the incentives for U.S. corporate taxpayers to try to shift their income abroad. Third, in identifying the scope of the problem and the income shifted, we agree that it is useful to look for anomalies. For example, there are many jurisdictions where U.S. corporations report profits that constitute multiples of that jurisdiction's GDP;[5] it is clearly impossible that the reported income was actually earned in that jurisdiction in a real sense. Another — and related anomaly — is that assets and people in some jurisdictions seem to produce gigantic amounts of reported income relative to similar assets in other jurisdictions.[6] Of course, workers in these jurisdictions are not really more profitable; the excess profitability is just an artifact of income shifting.

Again, as a result of the 2017 federal tax legislation, the U.S. is no longer even trying to tax corporations on their worldwide income. GILTI is therefore an attempt to counter an *increased* incentive to shift income, and it does so by applying the reasonable notion that excessive profitability indicates shifted income.

It must be noted, however, that GILTI was not carefully crafted and much remains unknown as to how well it will actually operate in practice. Notably, certain prominent commentators, such as the Congressional Budget Office,[7] do not expect it to be very effective. One issue is that the deemed normal rate of return is pretty high.[8] Others have argued that many non-income-shifting taxpayers will be saddled with large amounts of GILTI because of the way GILTI calculates the asset base on which a taxpayer is permitted a normal return.[9] This might be so, though we would be surprised if, even over the short run, taxpayers did not find ways to increase their foreign asset base or engage in other maneuvers to reduce their GILTI.[10]

In any case, our point is not to evaluate GILTI as a matter of federal tax policy, but only to explain at a basic level what GILTI reasonably tries to do and likely will accomplish to at least some extent.

State Tax Policy From 20,000 Feet

In evaluating state tax policy options, we think it particularly important to start with opportunity-cost analysis. States operate under balanced budget constraints[11] and typically rely on three tax bases: personal income tax, corporate income tax, and the retail sales tax. Thus, the question whether to conform to GILTI is a question about (1) whether the cost of conformity is worth it given what the state will do with the money, and (2) whether raising revenue through GILTI conformity is appealing relative to the use of some other revenue instrument. Generally, GILTI conformity is appealing for several reasons:

1. Though states' needs vary greatly, we have little difficulty identifying significant needs on the revenue side. State revenues are cyclical, but spending needs are

[4] Jane G. Gravelle, "Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?" (Apr. 26, 2016) ("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.").

[5] Institute on Taxation and Economic Policy, "American Corporations Tell IRS That 61 Percent of Their Offshore Profits Are in 10 Tax Havens" (Nov. 5, 2017).

[6] Thomas R. Tørsløv, Ludvig S. Wier, and Gabriel Zucman, "The Missing Profits of Nations" at 19. ("Foreign firms in tax havens are an order of magnitude more profitable than local firms, while foreign firms in other countries are *less* profitable than local firms. That is, there is a clear trace in global macro data of movements of profits within divisions of multinational groups, away from high-tax affiliates and towards low-tax affiliates.").

[7] Congressional Budget Office, "The Budget and Economic Outlook: 2018 to 2028," at 124, 127 (Apr. 2018). *See also* Kimberly A. Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act" (Oct. 29, 2018).

[8] Rebecca Kysar, "Critiquing (and Repairing) the New International Tax Regime," 128 *Yale L. J.* Forum 339 (2018). Other issues include the ability to apply foreign tax credits across jurisdictions. *Id.* States do not offer credits, but to the extent the provision of credits at the federal level makes GILTI less effective at combating income stripping, then the states will suffer.

[9] *See*, for example, Joseph X. Donovan et al., "State Taxation of GILTI: Policy and Constitutional Ramifications," *State Tax Notes*, Oct. 22, 2018, p. 315.

[10] Richard Rubin, "Qualcomm Tax Move Will Save Firm $570 Million," *The Wall Street Journal*, Jan. 30, 2019. It appears that Qualcomm has moved to do its foreign business through branches, rather than CFCs, to avoid GILTI and BEAT — and to take advantage of FDII. Note that this strategy could increase Qualcomm's state corporate income tax liability depending on how these changes interact with its water's-edge election. *See also* Mitchell Goldberg and Bryan Appel, "Sometimes GILTI Is a Pleasure," *Law360*, Jan. 31, 2019 (additional thoughts on tax planning to reduce tax liability in a GILTI world).

[11] For discussion, see David Gamage, "Preventing State Budget Crises: Managing the Fiscal Volatility Problem," 98 *Calif. L. Rev.* 749 (2010).

counter-cyclical — so simply taking revenue raised by GILTI conformity and using it to shore up state reserve funds would be money well spent.

2. As an administrative matter, the primary benefit from conformity is that it is easy. To be sure, as we will discuss in a forthcoming essay, taxing GILTI at the state level does implicate apportionment issues, but we do not believe those need to create significant new compliance burdens.
3. As a distributive matter, taxing GILTI is relatively progressive. The incidence of the corporate income tax is a longstanding mystery, much less the incidence of GILTI, but some portion of the tax is borne by shareholders. Thus, conforming to GILTI makes state taxes more progressive when state tax systems are relatively regressive at a moment of rising income inequality.
4. At its core, GILTI is a base-broadening provision. Raising additional revenue by broadening the base is, *ceteris paribus*, more efficient than increasing taxes. Even if a state had no interest in new revenue or making its tax system more progressive, it would still benefit from pairing conformity to GILTI with a reduction in its corporate income tax rates.

Into the Weeds With GILTI

States have been struggling with the disproportionate erosion of their corporate tax bases for a long time.[12] Indeed, there is a compelling argument that the answer that some states arrived at by the 1980s — mandatory worldwide combination with formulary apportionment — remains the best available option for both U.S. states and national governments.[13] The benefit of this system is that it does not matter where a unitary business says that it earns income; the income will be apportioned to a jurisdiction based on some reasonable metric. This system represents the opposite of the current regime. Under mandatory worldwide combination, the assumption is that assets earn about the same rate of return wherever located, a much more reasonable (if imperfect) surmise than the current system that — as noted — must countenance that there are super assets in particular super jurisdictions.

Regrettably, in a story that has been amply explained elsewhere,[14] the U.S. government, under pressure from foreign governments, pressured states to abandon worldwide combination. Moreover, federal tax policy has further encouraged erosion of the shared federal and state corporate tax bases in a number of ways, including: (1) instituting the check-the-box regulations, which undermined subpart F (a Kennedy-era attempt to curb income stripping),[15] and (2) providing and proposing repatriation holidays, which have further encouraged income shifting.[16] Thus, the federal government has forced states to abandon their best tool to counter profit shifting while simultaneously exacerbating the profit-shifting problem.

This is the story that has brought us to GILTI, which we consider to be a serious, if partially flawed, attempt by the federal government to counter a problem that federal tax policy was otherwise going to make dramatically worse by shifting to a territorial system for the corporate tax base. In other words, more than 30 years after claiming it intended to help states counter profit shifting to make up for the loss of worldwide combination,[17] the federal government has finally — if not exactly deliberately — made good on this

[12] *See* Mazerov, *supra* note 3.

[13] *See* Jerome R. Hellerstein, "Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment," *State Tax Notes*, Aug. 23, 1993, p. 407; and Darien Shanske, "White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting," *State Tax Notes*, Sept. 17, 2018, p. 1181.

[14] *See* Hellerstein, *supra* note 13.

[15] Lawrence Lokken, "Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations," 7(186) *Fla. Tax Rev.* (2005). Note that the check-the-box regulations were apparently the weapon used by Qualcomm to reduce its tax liability under the GILTI regime.

[16] Lisa De Simone, Joseph D. Piotroski, and Rimmy E. Tomy, "Repatriation Taxes and Foreign Cash Holdings: The Impact of Anticipated Tax Reform" (Dec. 7, 2017).

[17] The second principle on which there was agreement of the Worldwide Unitary Taxation Working Group was that there should be "increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability." U.S. Department of the Treasury, "The Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views," at 9. Congress never passed the necessary legislation. Multistate Tax Commission, "Timeline of Events in the History of the MTC."

commitment. With this background, it seems clear to us that states should take this opportunity and, ideally, improve it.

The converse of conforming and getting at least some base expansion from GILTI is to suffer the further unmitigated erosion of the corporate tax base that the 2017 federal tax legislation would incentivize without GILTI. To go back to opportunity-cost analysis, this will mean that some other taxpayers or government programs will have to pay the price.

Conclusion

Of course, just because the states should (in our view) conform to GILTI does not mean that they can. Accordingly, we will present the legal analysis for how states can do so in a forthcoming essay.[18] For now, we will conclude this essay with a short preview of that analysis. Modern dormant commerce clause jurisprudence — indeed, modern federal constitutional law more generally — puts a thumb on the scale when it comes to state power, particularly as to revenue-raising. It would be quite surprising, therefore, if the states were to be forbidden from conforming to a provision that reasonably — if imperfectly — shores up their ability to tax corporate income. ■

[18] If you can't wait, see Shanske, "Once More on States and GILTI: States Should Conform to GILTI (And Why I Believe They Will (Eventually))" Medium.com (Dec. 27, 2018).