2-13-2023

Why States Should Conform to the New Corporate AMT

David Gamage
Darien Shanske

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

Part of the Taxation-State and Local Commons, and the Tax Law Commons
Why States Should Conform to the New Corporate AMT

by Darien Shanske and David Gamage

Reprinted from *Tax Notes State*, February 13, 2023, p. 601
Why States Should Conform to the New Corporate AMT

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, Bloomington, Maurer School of Law.

In this installment of Academic Perspectives on SALT, Shanske and Gamage argue that states should conform to the recently enacted corporate alternative minimum tax to combat corporate profits shifting and offer suggestions for implementation.

Introduction

In 2022, as a key component of the Inflation Reduction Act, Congress enacted a new corporate alternative minimum tax (CAMT). With the possible exception of Alaska, states with corporate income taxes will not automatically conform to this change. But should they? Although states may not currently be seeking additional tax revenue, seasons change quickly when it comes to revenue needs.

Further, there is increasing reason to believe that the corporate income tax is a progressive tax, and if so, a state might consider conforming to the CAMT as part of a revenue-neutral change to make its tax system more progressive.

Accordingly, in this article we explain why states should and how they could conform to the CAMT. Essentially, we argue that states should take further steps to combat international profit-shifting forms of tax avoidance (such as moving in the direction of worldwide combined reporting) and that conforming to the new CAMT is a good step in that direction.

The Key Underlying Issues

The CAMT — like global intangible low-taxed income and the OECD pillars — is primarily a response to the perception that some very profitable multinational corporations are not paying their fair share of tax. There is debate as to whether this is true, but suffice it to say that we agree that income shifting is a problem that should be addressed.

The CAMT responds to this problem in two primary ways. First, it requires aggregation of corporations so that income shifted to a foreign subsidiary does not escape tax. Second, the CAMT does not use taxable income as its base. Rather, it uses financial reporting income (with modifications). The intuition behind this choice is that taxpayers generally have incentive to inflate rather than suppress financial reporting income and, further, that there are independent monitors.

Note:

5. IRC section 56A(c)(3).
6. IRC section 55(b)(2); section 56(A)(b).
of financial income (for example, shareholders), as well as liability for misreporting in many cases (for example, from securities law). The CAMT only applies to large corporations — generally those with average financial statement income of over $1 billion over three years.\(^7\)

We think that aggregating corporate groups makes sense, as does using financial reporting as a backstop. And we are not the only ones, as that is essentially what the OECD’s pillar 1 proposal would do for a similar set of large corporations.\(^8\) Of course, it would arguably make more sense to reform the corporate income tax system directly, as opposed to through an AMT mechanism. Further, there is perhaps some danger of overly influencing financial accounting practices, which is why not relying on financial reporting income at a one-to-one ratio also makes sense. This is why the CAMT only kicks in if financial reporting income is more than about 30 percent less than taxable income.\(^9\)

In short, conforming to the CAMT makes sense for the same reasons the tax itself makes sense; this is a change that would capture some shifted income that is escaping both federal and state tax bases. The necessary statutory language would not be difficult. A state could require taxpayers subject to the federal CAMT to calculate state CAMT liability at some lower rate (perhaps 75 percent of the regular rate), using the federal CAMT base as a start, with adjustments for apportionments and other items discussed in the next section.

\(^7\) There are also aggregation rules to prevent taxpayers from splitting up to stay below the threshold. IRC section 59(k)(1)(D). There is a special rule for foreign-parented multinationals; they must be over the $1 billion threshold and their U.S. corporations must have $100 million in financial statement income, averaged over three years. IRC section 59(k)(1)(B)(ii).

\(^8\) For instance, a covered group has $20 billion of income and financial accounting profit is used to calculate taxable profit. OECD, “Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy,” at tbl. 1, art. 1, section 2(a) (July 11, 2022).

\(^9\) Daniel Shaviro proposes a similar ratio: “Publicly traded corporations with at least $10 million of assets, which under current law must file both Schedule M-3 and SEC Form 10-K, would be required to adjust taxable income (as otherwise determined) by 30 percent of the difference between such income and modified financial accounting income”; Shaviro, “The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal,” 97 Geo. L.J. 423, 475 (2009).

Tax Base Design/Revenue Potential

The Joint Committee on Taxation has projected that the CAMT will raise about $222 billion over 10 years.\(^10\) Rounding to $20 billion per year and reversing the math ($20 billion/15 percent) indicates that the JCT is predicting that the CAMT will boost the federal corporate tax base by about $130 billion per year. Assuming, say, a 5 percent state CAMT rate and the same base, this would yield $6.5 billion in additional state revenue.

However, many reasonable design choices could greatly increase the additional tax base yielded by a state CAMT. First, the tax due under the federal CAMT is net of foreign taxes.\(^11\) States do not grant foreign tax credits, so the question is how much the JCT’s final estimate takes foreign taxes into account. We do not know of a good public estimate of how much these credits are likely to be, but we note that in 2017, the last year the U.S. formally had a worldwide system, corporations took about $76 billion in FTCs on about $272 billion in foreign-source taxable income.\(^12\) There are reasons that number might be too low or too high as for the CAMT credits, but we think the scale is likely roughly right. If so, this would imply a state CAMT tax base closer to $200 billion.

This is not even the most significant reason why the potential tax base for a state-level CAMT could be significantly larger than what is implied by the JCT projection. Most states do not conform to GILTI,\(^13\) but the federal CAMT essentially applies after taking into account that taxpayers have paid for GILTI under the regular tax system. Currently GILTI is taxed at 10.5 percent. Taking a simple example, suppose that a taxpayer subject to the CAMT had $100 million of GILTI from a controlled foreign corporation. That taxpayer would thus already have had to pay $10.5 million in tax on that GILTI. Suppose further that the taxpayer added $100 million of the book income


\(^11\) IRC section 59(k).

\(^12\) IRS, Statistics of Income, Corporate Foreign Tax Credit, Tax Year 2017.

from that CFC under the CAMT; the taxpayer would owe the difference between the $10.5 million paid on its GILTI and the 15 percent CAMT on the $100 million, or $3.5 million more in CAMT. The JCT estimate is only based on that final increment of $3.5 million and assumes tax paid on GILTI.

By contrast, at the state level, for the most part, the ordinary corporate income tax calculation does not include GILTI, so the broader tax base consisting of financial reporting income is likely going to yield a higher relative number. To be more precise, we note that about $340 billion in GILTI was reported in 2018. If one assumes that all of this income also would show up on financial statements even though (usually) not included in taxable income at the state level, then that would boost the state-level CAMT base by more than 100 percent to about $500 billion (given that our running estimate to this point was about a $200 billion increase).

Some additional hedging is in order here. The total GILTI number is for all taxpayers and not just the biggest ones subject to the CAMT. Yet the largest businesses ($2.5 billion and more) accounted for about 90 percent of GILTI, so a sizeable portion of GILTI should be captured by a state-level CAMT that also applied to the largest taxpayers. Pushing the other way, a tax base consisting of financial reporting income would not include a reduction for a 10 percent return on qualified business asset investment, a reduction worth $57 billion — of which $51 billion was attributed to those same largest taxpayers.

There are other design factors that could increase the state CAMT base as well. At the last moment, the CAMT was changed to allow for the greatly accelerated depreciation permitted by the tax code — as opposed to that of financial accounting. This reduced the CAMT’s yield from $313 billion over 10 years to $222 billion. States generally do not allow for such generous depreciation, suggesting that the state-level base of the tax could further increase by as much as $50 billion annually ($10 billion/year divided by 21 percent).

All of this considered, we will very roughly estimate — fully acknowledging the great uncertainty — that conforming to the CAMT could increase the state corporate tax base by about $500 billion.

Compared with the current state corporate tax base, this is a big number. Assuming a 7 percent average rate, that base would have been $614 billion based on $43 billion of state corporate income tax in 2017. Yet state collections have increased dramatically, to $59.5 billion in 2019 (implying a tax base of $850 billion) and $88.7 billion in 2021 (implying a base of $1.2 trillion). We suspect a regression to 2017 is likely, but even taking 2021 as a baseline, the addition of the CAMT base could be significant.

Each state would need to have a theory justifying how much of this new tax base can be fairly apportioned to it. We focus on one simplifying option here as to how to deal with apportioning any incremental income raised by a state CAMT. We propose, as a floor, including something like 40 percent of the increment. As we have discussed previously, GILTI itself is based on a reasonable assumption that 50 percent of shifted income is shifted out of the United States, hence 40 percent represents a conservative estimate that taxpayers could

---

14 The CAMT and GILTI both include the pro rata share of the income as determined under IRC section 951(a)(2). See IRC section 951A(e); section 56A(c)(3)(A).
15 IRS, SOI, Table 1, supra note 12. Form 8992, “U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),” Selected Items, by Size of Total Assets of Parent, Tax Year 2018. Note that Penn Wharton Budget Model did very well at predicting the amount of GILTI in 2018 and predicts roughly similar amounts of GILTI increasing slightly, over the next few years. Alexander Amon and Marko Paulson, “Projections of Global Intangible Low-Taxed Income: A Validation Exercise,” Penn Wharton Budget Model (July 16, 2021).
16 IRS, SOI, Table 1. Form 8992, “U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),” Selected Items, by Size of Total Assets of Parent, Tax Year 2018.
17 Id.
18 IRC section 56A(c)(13).
19 JCT Memo to Senate Finance Committee, No. 22-2 027 R4 (July 28, 2022).
20 Another factor weighing in favor of the state-level increase being greater than that at the federal level is that the CAMT permits the use of tax credits to reduce up to 75 percent of CAMT liability. IRC section 38(c)(6)(E). States would need to decide how to apply their credits; we do not recommend a similarly high percentage.
petition for relief from or (often) elect out of by means of worldwide combination. This option could still amount to something like $200 billion more in corporate tax base for the states. To repeat, these back-of-the-envelope numbers are primarily meant to illustrate that there is significant revenue at stake, which is the case because there are sound policy choices states can make to tweak the CAMT and make it more effective at reaching shifted income.

**Worldwide Combined Reporting**

As to the permissibility of taxing a measurement of shifted income, we think that if states can implement worldwide combined reporting, and they can, then they can conform to the new CAMT as an alternative approach for achieving this goal.

Looking more broadly to the overall policy considerations, conforming to the new CAMT is a good option for addressing the problem of income shifted abroad. Nevertheless, it might be even better to just move to worldwide combined reporting, which obviates the need to ponder how to represent foreign factors and relieves some of the pressure on state revenue agencies to learn how to deal with financial statements.

It is further worth emphasizing that the new federal CAMT makes it substantially easier — in terms of administration and compliance — for the states to require worldwide combined reporting for taxpayers already subject to the tax. Worldwide combined reporting opponents have long complained that it requires domestic taxpayers to calculate the income for state tax purposes of their foreign affiliates. But this has never been a very strong claim because the worldwide combined reporting rules tend to be forgiving. For instance, California has long permitted “reasonable approximation” based on ordinary financial records for calculating the income of foreign subsidiaries, an approach explicitly approved by the U.S. Supreme Court in *Barclays*. Indeed, the evidence adduced in the litigation concerning worldwide combined reporting in *Barclays* concluded that the costs involved were “relatively modest.” Further, taxpayers seem able and willing to do these calculations when they might be to their own advantage.

Of course, “relatively modest” costs are not zero. We acknowledge that some taxpayers might just take the water’s-edge election by default to not have to pay their U.S. tax accountants to analyze the financial accounting of their foreign subs. But guess what? For any taxpayer subject to the new federal CAMT, this more or less already has to be done.

This raises another promising reform option foreshadowed above: The states could offer taxpayers subject to the new federal CAMT the choice of either paying an additional state-level CAMT with a simplified apportionment formula or opting for worldwide combined reporting.

A final tweak — and perhaps the most promising — would be to require that taxpayers subject to the CAMT pay tax on a worldwide combined basis or CAMT, whichever is higher; in
other words, to retain the CAMT as a minimum tax. This reform option should be constitutional and would offer the following policy advantage. Worldwide combined reporting does not require the use of financial accounting information, though this information is likely used for at least some foreign subsidiaries. The CAMT, however, requires that this information be used because it is, itself, an antiabuse device. In other words, both worldwide combined reporting and the CAMT use aggregation as a strategy to combat income shifting. But only the CAMT uses accounting statements as an additional check on income shifting. Worldwide combined reporting only uses accounting statements as a tool. It would thus be sensible for a state to adopt both.

Conclusion

We understand that most states are not likely to be clamoring for more revenue in the short term. Nevertheless, conforming to the new CAMT is clearly a sensible, progressive, fair, and administrable option that can raise substantial revenue. Additional revenue will almost certainly be needed at some point, and we recommend conforming to the new CAMT as a promising option for raising that revenue. More fundamentally, as the ongoing ferment around the OECD pillars and CAMT demonstrates, we agree with the broader policy consensus that the highly mobile capital of large multinationals should be subject to closer to an equivalent rate of tax as their less-mobile domestic competitors.

29 See E.I. Du Pont de Nemours & Co. v. State Tax Assessor, 675 A.2d 82 (Maine 1996), and general discussion in Shanske, “How the States Can Tax Shifted Corporate Profits: An Application of Strategic Conformity,” 94 S. Cal. L. Rev. 251, 299-301 (2021). In particular, this option should be internally consistent because whichever calculation is higher should be higher for every state.