New York State Taxation of GILTI

Should States Tax GILTI, and if so, how?

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Background

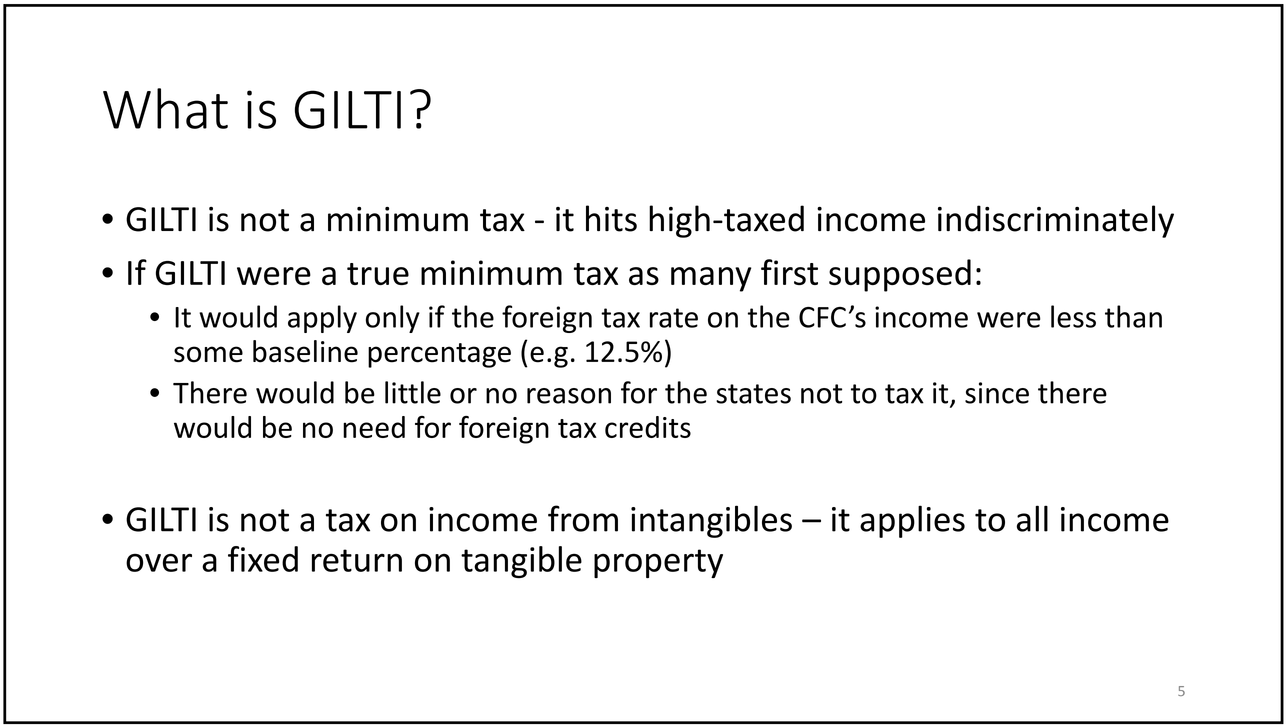
- The TCJA introduced GILTI under Section 951A of the Internal Revenue Code
- States have had to grapple with whether to conform to the new federal definition of taxable income, raising the question: should they include GILTI in the state income tax base, or de-couple from the federal tax determination of “taxable income”?
- States have previously addressed, in varying ways, the treatment of Subpart F income. Should the same treatment be extended to GILTI?

Today’s discussion

- What is GILTI?
- What have New York and various states done in relation to GILTI so far?
- Can states tax GILTI, even if no FTC is offered by the State tax rules?
- Constitutionality considerations/concerns (if GILTI is in the tax base)
  - Fair apportionment
  - Discrimination against foreign commerce

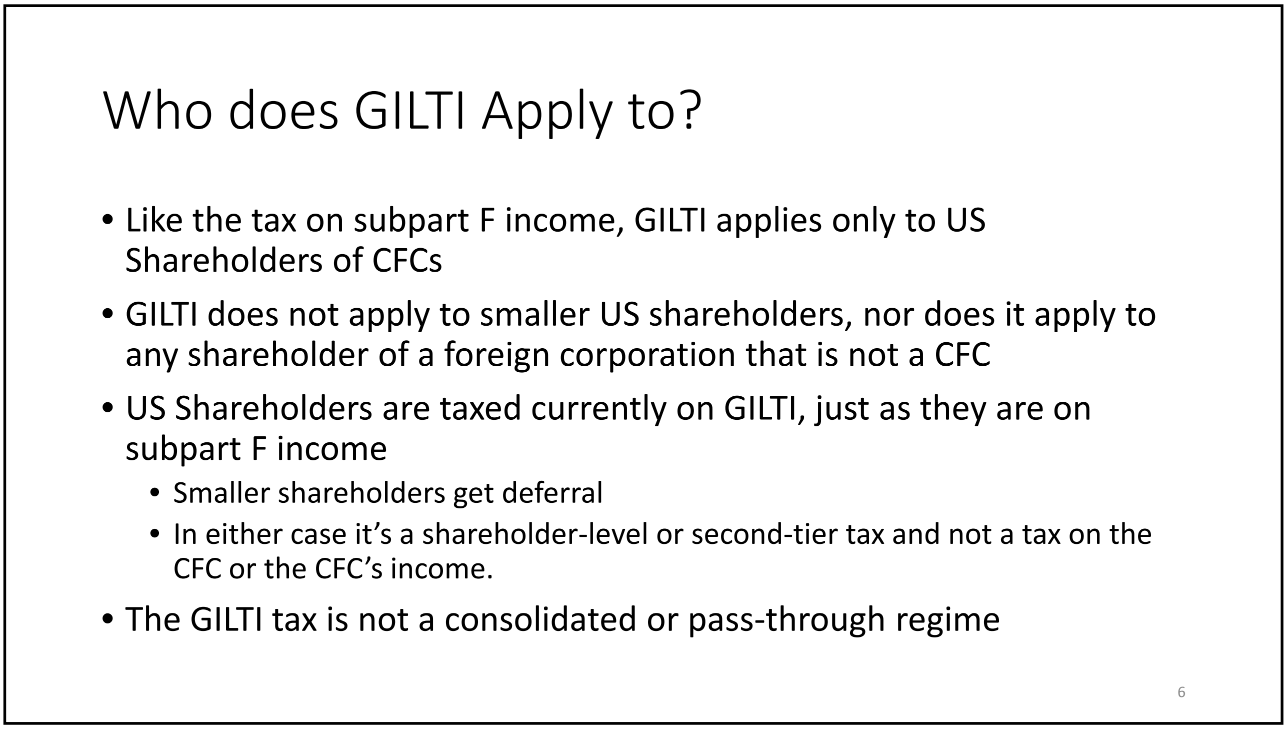
What is GILTI?

- GILTI is a tax on a “US Shareholder” of a “Controlled Foreign Corporation” (CFC)
  - A US Shareholder is a US person that owns at least 10% of the stock of the foreign corporation by vote or by value
  - A CFC is a foreign corporation over 50% owned, by vote or by value, by US Shareholders
  - Indirect and constructive ownership rules apply
- The amount of a US Shareholder’s GILTI is the net tested income of all of its CFCs less 10% of the unleveraged adjusted basis of the tangible property of its CFCs that have tested income



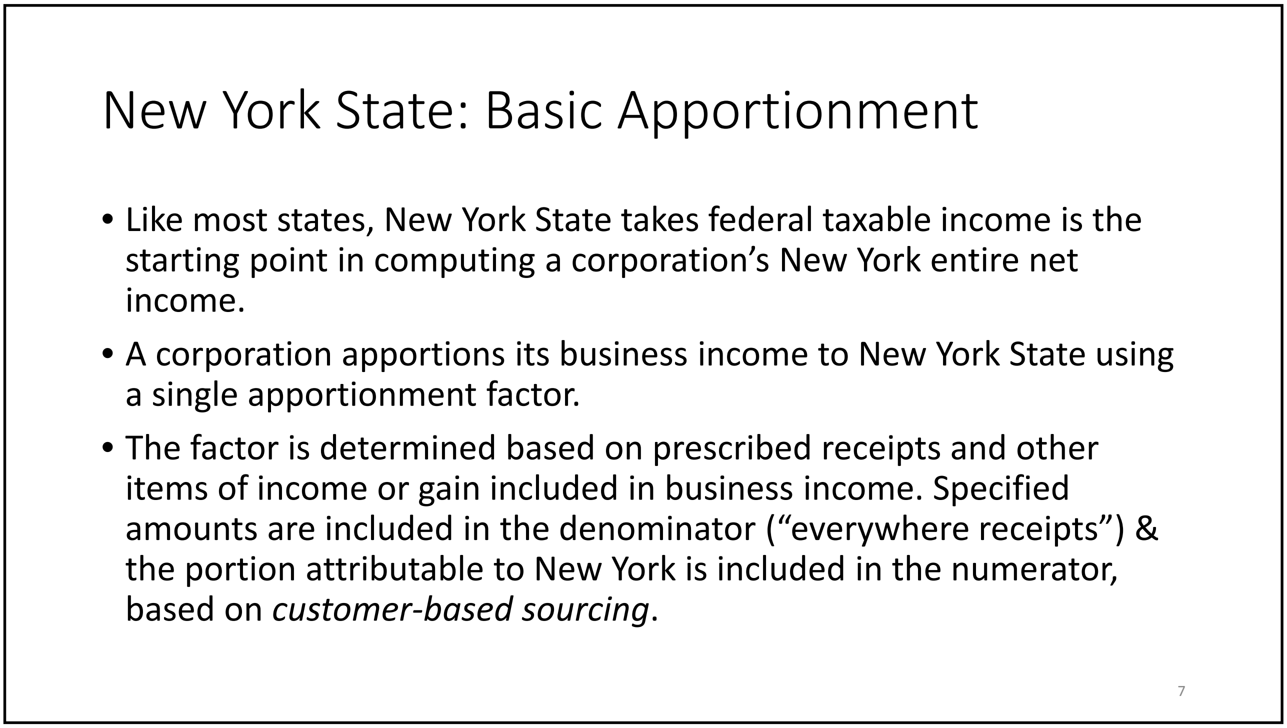
What is GILTI?

- GILTI is not a minimum tax - it hits high-taxed income indiscriminately
- If GILTI were a true minimum tax as many first supposed:
  - It would apply only if the foreign tax rate on the CFC's income were less than some baseline percentage (e.g. 12.5%)
  - There would be little or no reason for the states not to tax it, since there would be no need for foreign tax credits
- GILTI is not a tax on income from intangibles – it applies to all income over a fixed return on tangible property



Who does GILTI Apply to?

- Like the tax on subpart F income, GILTI applies only to US Shareholders of CFCs
- GILTI does not apply to smaller US shareholders, nor does it apply to any shareholder of a foreign corporation that is not a CFC
- US Shareholders are taxed currently on GILTI, just as they are on subpart F income
  - Smaller shareholders get deferral
  - In either case it's a shareholder-level or second-tier tax and not a tax on the CFC or the CFC's income.
- The GILTI tax is not a consolidated or pass-through regime



New York State: Basic Apportionment

- Like most states, New York State takes federal taxable income is the starting point in computing a corporation’s New York entire net income.
- A corporation apportions its business income to New York State using a single apportionment factor.
- The factor is determined based on prescribed receipts and other items of income or gain included in business income. Specified amounts are included in the denominator (“everywhere receipts”) & the portion attributable to New York is included in the numerator, based on *customer-based sourcing*.

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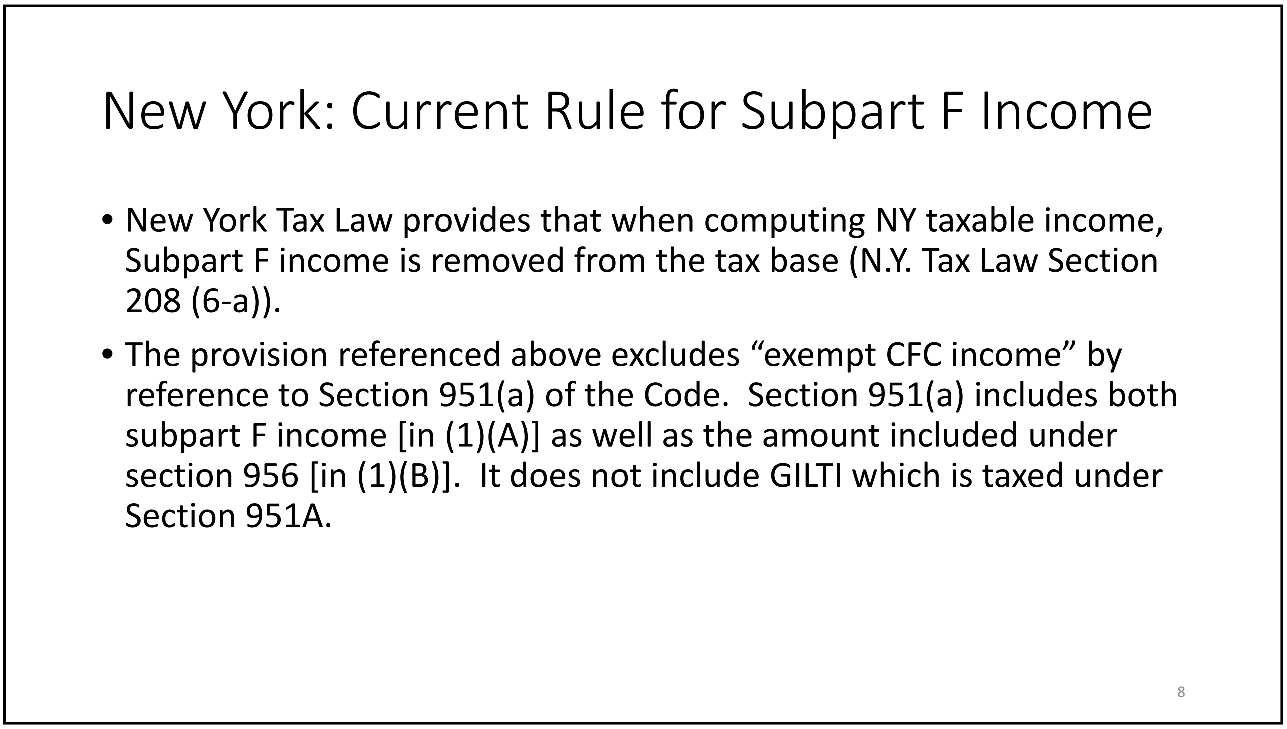

New York: Current Rule for Subpart F Income

- New York Tax Law provides that when computing NY taxable income, Subpart F income is removed from the tax base (N.Y. Tax Law Section 208 (6-a)).
- The provision referenced above excludes “exempt CFC income” by reference to Section 951(a) of the Code. Section 951(a) includes both subpart F income [in (1)(A)] as well as the amount included under section 956 [in (1)(B)]. It does not include GILTI which is taxed under Section 951A.

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How Should States Think About GILTI?

- Example #1A: Assume US corporation operates in multiple US states directly (i.e. through local branches) and has no operations outside the United States
  - In the case of a branch, all of the income is included in the US corporation's income.
  - The US corporation is subject to state tax on this branch income, subject to the apportionment rules imposed by the state.
- If all states used exactly the same definition of taxable income and exactly the same apportionment formula, each state would tax a portion of the US corporation's income and there would be no double taxation
  - This is not generally true in fact – states have different measures of income and different apportionment factors (and some states do not impose an income tax), but the Constitution allows rough justice
  - Would there be any constitutional issue if one state asserted the right to tax 100% of the corporation's income (e.g. based on domicile without apportionment), while other states taxed some of its income? Clear case of double taxation

How Should States Think About GILTI?

- Example #1B: Assume that a US corporation operates outside the United States directly, i.e. through a branch
  - In the case of a branch, all of the income is included in the US corporation's income.
  - The US corporation is subject to state tax on this branch income, subject to the apportionment rules imposed by the state.
  - It is also subject to tax in the country where it operates as a branch
- Even if all states used the same measure of income and the same apportionment factors, there would be double taxation of the income subject to tax in the foreign country
  - A foreign tax credit could relieve double taxation, but which states would be required to provide it? Not used in practice
  - Would a deduction for the foreign tax, apportioned among the states, make sense? Kraft noted that this is only partial relief

How Should States Think About GILTI?

- Example #2A: Assume that a US corporation has no operations or income outside the United States, but operates through wholly-owned subsidiaries in multiple US states
- Most states respect separate entities
- Some states permit or require combined reporting among affiliated corporations
- Dividends received from a subsidiary are generally excluded
- As in Example #1A, this normally works reasonably well, particularly given that many states with an income tax use federal measures

How Should States Think About GILTI?

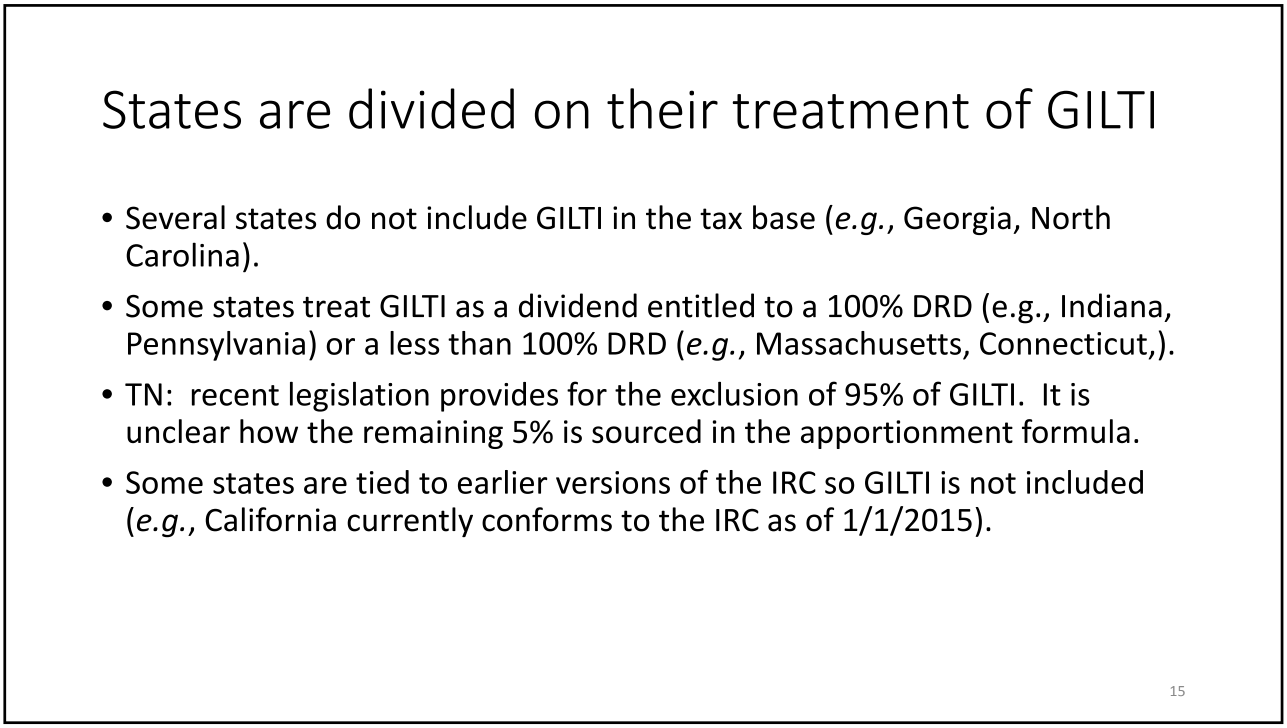
- Example #2B: Assume that a US corporation operates through wholly-owned subsidiaries in multiple US states and through one or more CFCs in foreign countries
- Do states permit combined reporting with non-US subs? Generally, no
- Do states exclude dividends from non-US corporations? Generally, yes
- Absent some accommodation, this will result in double taxation in the same manner as Example #1B
  - But unlike Example #1B, here an exclusion for dividend income can solve the double taxation problem
  - A solution to Example #1B is a territorial exclusion that works the same way as a dividends-received deduction
  - Note that in the TCJA, Congress eschewed territoriality for dividend-equivalent branch income!

New York State: GILTI

- NY has adopted a statutory provision requiring the inclusion of GILTI net of the § 250 deduction (“net GILTI”) to be included in the apportionment factor.
- Net GILTI is included in the denominator of the fraction but no amount of GILTI is included in the numerator.
- The rule is based on the assumption that the amount of a corporation’s net GILTI from the CFC constitutes business income to the corporation, rather than investment income or other exempt income.

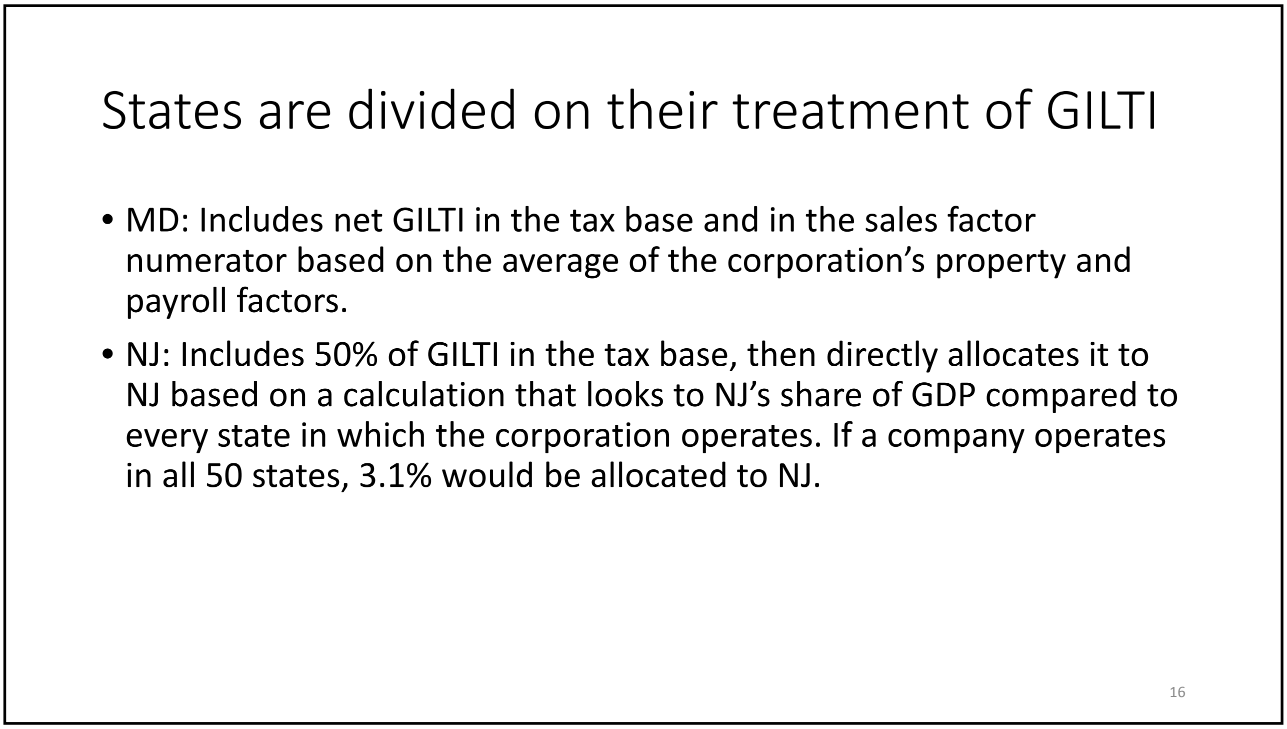
Can States impose tax on all (or some) GILTI?

- Should a state’s decision to tax or decouple from GILTI be impacted by a system that does not have worldwide combination, but in the domestic context has de-facto combination?
- If GILTI is taxed, there is a real risk of over-inclusiveness.
- States have tried to address this over-inclusiveness in different ways.



States are divided on their treatment of GILTI

- Several states do not include GILTI in the tax base (*e.g.*, Georgia, North Carolina).
- Some states treat GILTI as a dividend entitled to a 100% DRD (e.g., Indiana, Pennsylvania) or a less than 100% DRD (*e.g.*, Massachusetts, Connecticut,).
- TN: recent legislation provides for the exclusion of 95% of GILTI. It is unclear how the remaining 5% is sourced in the apportionment formula.
- Some states are tied to earlier versions of the IRC so GILTI is not included (*e.g.*, California currently conforms to the IRC as of 1/1/2015).



States are divided on their treatment of GILTI

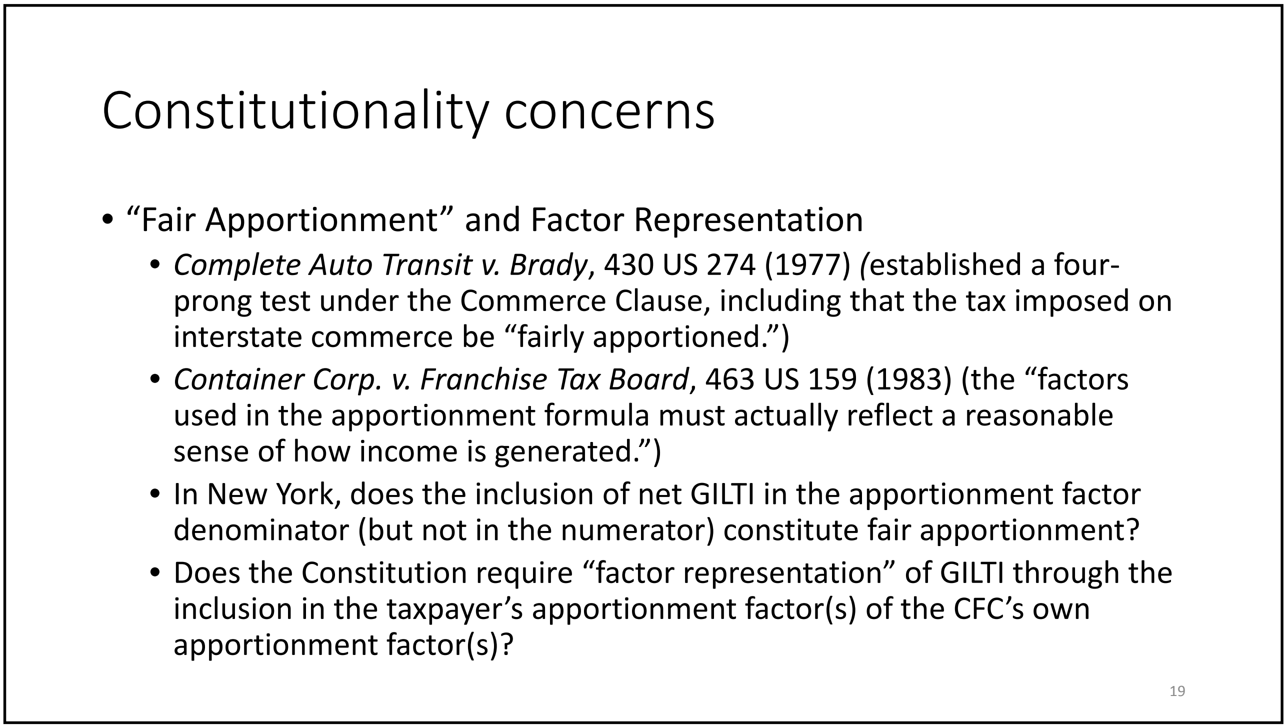
- MD: Includes net GILTI in the tax base and in the sales factor numerator based on the average of the corporation’s property and payroll factors.
- NJ: Includes 50% of GILTI in the tax base, then directly allocates it to NJ based on a calculation that looks to NJ’s share of GDP compared to every state in which the corporation operates. If a company operates in all 50 states, 3.1% would be allocated to NJ.

Should GILTI Be Treated the Same As Subpart F Income?

- Similarities between subpart F income and GILTI
  - Both apply only to US Shareholders of CFCs and do not affect shareholders of other foreign corporations, or less than 10% US shareholders
  - Both operate as a second-level tax in a classical double-tax corporate framework
  - Both are income earned by a CFC (a foreign corporation not otherwise subject to US tax) but taxable currently to a “US Shareholder”
  - Both are exempt from further tax when distributed, having already been taxed once - single tax at shareholder level
- Differences between subpart F income and GILTI
  - Subpart F applies only to enumerated categories of income thought to be passive or mobile, whereas GILTI applies to all income, including active operating income, over a 10% return on unleveraged adjusted basis in tangible depreciable property, if any
  - GILTI is a tax based on rolling up the income and loss of all of a US shareholders’ CFCs
  - GILTI is not limited by “earnings and profits”

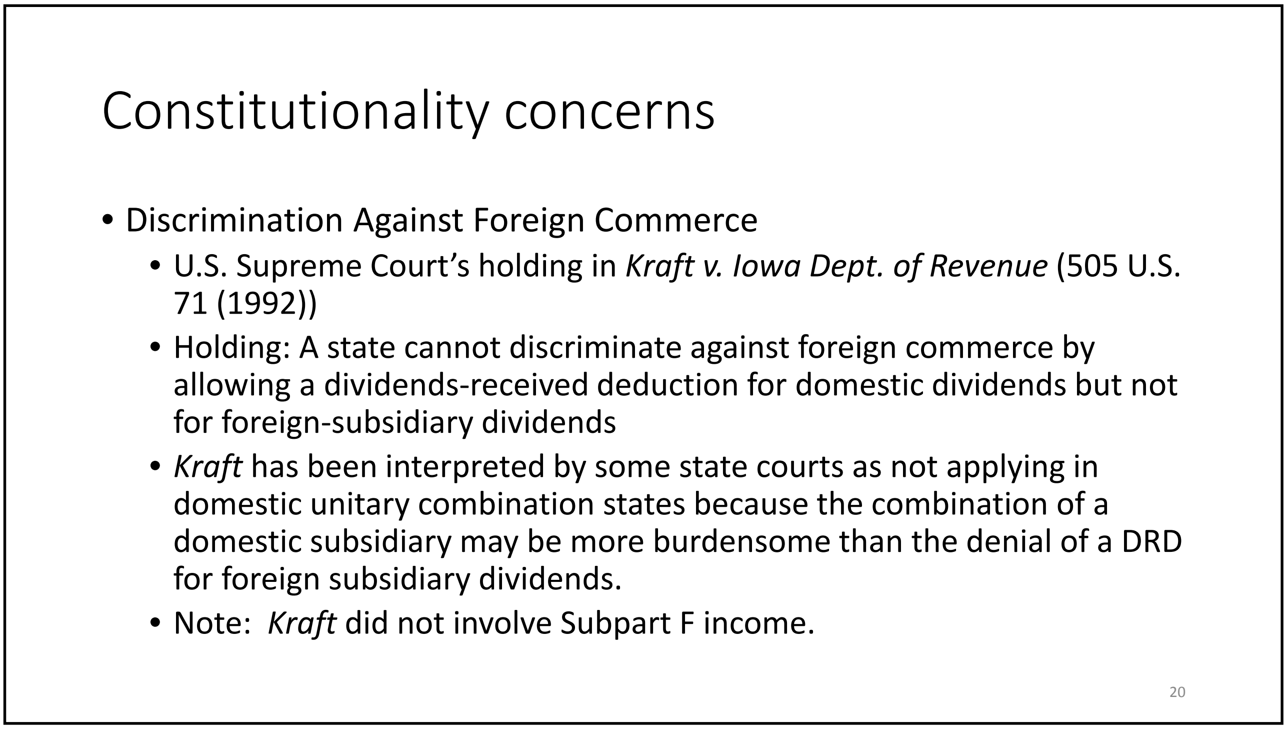
State Treatment of Subpart F Income

- The vast majority of states do not include Subpart F income in a corporation’s income tax base subject to apportionment.
  - This is accomplished either by a DRD or a statutory exclusion for Subpart F income.
- A handful of states include all or a portion of Subpart F income in the tax base.
  - At least one of those states (Colorado) includes the Subpart F income in he denominator (but not in the numerator) of the corporation’s sales factor.



Constitutionality concerns

- “Fair Apportionment” and Factor Representation
  - *Complete Auto Transit v. Brady*, 430 US 274 (1977) *(*established a four-prong test under the Commerce Clause, including that the tax imposed on interstate commerce be “fairly apportioned.”)
  - *Container Corp. v. Franchise Tax Board*, 463 US 159 (1983) (the “factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.”)
  - In New York, does the inclusion of net GILTI in the apportionment factor denominator (but not in the numerator) constitute fair apportionment?
  - Does the Constitution require “factor representation” of GILTI through the inclusion in the taxpayer’s apportionment factor(s) of the CFC’s own apportionment factor(s)?



Constitutionality concerns

- Discrimination Against Foreign Commerce
  - U.S. Supreme Court’s holding in *Kraft v. Iowa Dept. of Revenue* (505 U.S. 71 (1992))
  - Holding: A state cannot discriminate against foreign commerce by allowing a dividends-received deduction for domestic dividends but not for foreign-subsidiary dividends
  - *Kraft* has been interpreted by some state courts as not applying in domestic unitary combination states because the combination of a domestic subsidiary may be more burdensome than the denial of a DRD for foreign subsidiary dividends.
  - Note: *Kraft* did not involve Subpart F income.