Massachusetts Taxpayers Foundation

TAXING GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI) IS COMPLICATED, COSTLY AND COULD BE UNCONSTITUTIONAL

Introduction

The Massachusetts Taxpayers Foundation is a non-profit, non-partisan research organization dedicated to the state's fiscal stability and long-term economic growth. That mission compels us to outline for policymakers our concerns with the proposal to tax global intangible low-taxed income (GILTI) at 50%. While MTF generally believes there are several infirmities with the current proposal to tax GILTI revenue, trying to use this revenue to finance transportation is especially ill-suited because the revenue is uncertain, will be difficult to collect in the short-term and is harder to leverage for capital financing than other transportation revenue sources that are more straightforward.

Key takeaways:

- At a time when the U.S. government is moving away from taxing worldwide income of corporations, Massachusetts would be trying to expand its jurisdiction globally. This approach directly conflicts with the federal approach while also causing unintended and harmful state-level consequences.
- At the federal level, the taxation of GILTI was coupled with a sizeable tax rate reduction and an offsetting foreign tax credit. Massachusetts has adopted neither, so this would be a straight tax increase.
- The premise of this proposal is to stop "base erosion" in Massachusetts; however this has been addressed at the federal level though the Tax Cuts and Jobs Act making the need for these provisions unnecessary.
- Only 6 states have clear statutory language to tax GILTI at 50% or more. Massachusetts would become an outlier among its competitor states if it were to adopt this change.[1]

[1] Star Partnership, State Conformity to Federal Tax Reform: Global Intangible Low-Taxed Income, January 1, 2020

- The proposal likely runs afoul of the Commerce Clause, which requires that the income from foreign corporations be treated the same as income of domestic corporations. Taxation of GILTI would likely face a protracted legal challenge.
- As the newly released Massachusetts Department of Revenue analysis indicates, the proposed change will generate $19 million not $450 million in new revenue and even this figure could be inflated if the appropriate apportionment is applied to the income.

Background

When Congress enacted the Federal Tax Cuts and Jobs Act of 2017 (TCJA) it made sweeping changes to the federal tax code in three areas: individual income tax, corporate tax and international tax. A primary purpose of TCJA was to make the US corporate tax code more competitive by more closely aligning the U.S. tax code with the tax codes of other countries in the Organization for Economic Co-operation and Development (OECD), the vast majority of whom had lower tax rates and a territorial taxing system.[2]

Prior to enactment of the TCJA, the United States imposed a worldwide tax system, subjecting U.S. firms operating abroad to U.S. taxes on their overseas profits. Foreign subsidiaries of U.S. firms did not have to pay those taxes so long as they kept related earnings overseas. This practice is known as deferral and was widely deployed because the U.S.'s corporate tax rates were among the highest in the world.

Although there were several benefits to better aligning the U.S. taxing regime with other developed countries through a territorial system, this system introduced its own set of complications. One such concern with a territorial system is that taxpayers are still incented to organize their business so that their earnings are subject to tax in lower-tax foreign jurisdictions. This practice is often referred to as "base erosion." To mitigate that practice, and to raise revenue to offset the federal cut in the corporate tax rate, Congress introduced a series of new rules at the federal level designed to work in tandem. GILTI is one of those new rules.

GILTI Defined

GILTI is a newly-defined category of foreign income added to corporate taxable income each year. Generally, it is a tax on foreign earnings that exceed a 10 percent return on a company's foreign tangible assets and are taxed in a foreign country at lower than a 13.125 percent rate on

[2] *Global Intangible Low-Taxed Income Taxation – A Primer* by Gordon Gray for the American Action Forum

an annual basis after federal credits apply. [3] Since MA doesn't allow a foreign tax credit, the MA definition of GILTI includes income that is taxed at a high rate, cutting against the federal policy. At its most basic level GILTI was designed as a revenue raiser (to offset tax cuts) and to function as a minimum tax and discourage base erosion tactics by mitigating the benefits.[4] Certain foreign income would be subject to tax if the tax rate in that foreign jurisdiction was deemed insufficient regardless of whether the money was *actually* distributed to shareholders.[5]

The global intangible low-taxed income (GILTI) was created under Internal Revenue Code (IRC) §951A. Per MASDOR TIR 19-11, GILTI is defined as the U.S. shareholder's excess (if any) of its "net Controlled Foreign Corporation (CFC) tested income" over its "net deemed tangible income return", as those terms are defined under Code § 951A.[6] A shareholder's pro rata share of GILTI is included in income without regard to whether the CFC actually distributed the amount to the shareholder.

A controlled foreign corporation's (CFC) U.S. shareholders, both corporate and non-corporate, are required to include their pro rata share of the CFC's "global intangible low-taxed income" ("GILTI") in gross income each year, starting in taxable years beginning after December 31, 2017. [7]

Problems with GILTI

The explanation of GILTI above, as technical as it is, masks its complexity when applied to real world situations and corporate structures that are not cut and dry. The amount of GILTI that a company would include in taxable income in any given year is determined by its unique circumstances, the changing tax policies of foreign governments and the complexities of the US tax code. Only after that federal calculation is complete would Massachusetts state tax laws apply and they add another layer of complexity to the calculation. While this new taxing system works somewhat imperfectly at the federal level, when applied at the state level it bumps up against the concepts of double taxation, apportionment, and constitutional limitations.

<u>Double Taxation.</u>

To the extent that GILTI is earned overseas, U.S. foreign subsidiaries may have paid foreign tax on that income already. To avoid double taxation at the federal level, the TCJA allows for taxpayers to claim credits against a portion of the foreign taxes paid.[8]

The federal government recognizes that not all (or even most) income earned overseas is done in pursuit of avoiding taxes. There are many legitimate reasons for U.S. companies to have

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[3] PwC *Tax Insights: US Tax Reform – Proposed GILTI Regulations And Implications For US Shareholders Of A Canadian Business*, Issue *2018-39*

[4] *The GILTI Effect: Tax Reform and Global Intangible Low-taxed Income*, BDO USA, July 2018

[5] See MA DOR Technical Information Release 19-11: Legislation Impacting the Massachusetts Tax Treatment of Selected International Provisions of the Federal Tax Cut and Jobs Act, Section C

[6] Mass DOR TIR 19-11, section C

[7] Id

[8] BDO United States, *The GILTI Effect: Tax Reform and Global Intangible Low-Taxed Income*, July 2018

operations beyond the U.S. borders – acquisition of subsidiaries for growth or economies of scale; desire to be closer to their customer base; or the need to be in close proximity to suppliers of goods and services. Despite its name, GILTI captures far more than income from intangible assets and low-tax jurisdictions.

At the state level, no such foreign tax credits are available. This means that Massachusetts could be attempting to tax income that has already been taxed by another taxing jurisdiction and for which the federal government has provided a credit without any such corresponding offset. This proposed approach is an aggressive expansion of Massachusetts' taxing jurisdiction.

Apportionment

The complexities of determining GILTI income raise issues beyond double taxation. Massachusetts is laying claim to income earned outside of its borders through its combined reporting statute on the theory that the foreign corporations at issue are related to the domestic companies in Massachusetts as part of a unitary business and that Massachusetts should determine the taxes owed in Massachusetts based on this broader definition of taxable income (i.e. Massachusetts would be getting a slice of a bigger pie). However, Massachusetts is not the only taxing jurisdiction attempting to tax that income. Thus, the income must be divvied up among all the jurisdictions laying claim to that income. That is done through apportionment.

Under current law GILTI is treated similarly to a dividend and allowed a 95% deduction with 5 percent subject to tax. The five percent is apportioned using *domestic* factors. If Massachusetts adopts the proposed expansion of GILTI from 5% to 50%, the income in question should no longer be considered a dividend. Instead, it will be ordinary income and as such, the income should be apportioned to Massachusetts using a formula that includes the foreign activity.

DOR's guidance makes this point clear. Currently GILTI in Massachusetts is treated as a dividend, and as such, it is not allowed to include any foreign apportionment factors in its Massachusetts apportionment formula - whether it is a business corporation or a financial institution. DOR goes on to provide the rationale for this treatment, stating "the statutory inclusion of five percent of dividends is intended as a disallowance of expenses of the corporation reporting the dividend income, rather than as a tax on the earnings and profits of the subsidiary corporation making the dividend. In general, an expense disallowance does not implicate the taxpayer's apportionment calculation."[9]

This distinction is important to understand because it has real implications if the tax treatment of GILTI is changed, and 50% of GILTI rather than 5% of GILTI is included in the income tax base. If GILTI was considered ordinary business income under the proposed change, then an apportionment formula including foreign factors should apply. If that is true, then a smaller portion of that income would be subject to tax in Massachusetts making the $450 million projection vastly inflated. How much of that income is taxable would differ per company based on its particular apportionment factors in any given year. That makes GILTI a volatile source of revenue and one that is not highly reliable for financing transportation capital investments.

[9] MA DOR TIR 19-11, Section IIC

Constitutional Issues

If Massachusetts were not to include the foreign factors (property, payroll and sales) of the (foreign) corporations earning GILTI in the denominator of a Massachusetts taxpayer's apportionment formula, then it would be treating foreign income differently than domestic income in violation of the Foreign Commerce Clause of the U.S. Constitution.[10] The proponents of taxing GILTI only address the constitutionality of its inclusion in the corporate tax base, and not the second requirement that it be properly apportioned.

Concerns with the Revenue Estimates

Proponents of using GILTI to fund transportation have indicated that their proposed changes would result in Massachusetts reaping $450 million.[11] That figure stands in stark contrast to the newly released Mass Department of Revenue estimate indicating that such a change would result in just $19 million in additional annual revenue.

There are many potential reasons for this discrepancy - the PWBM estimates were preliminary and reflected ongoing work at PWBM; the study only took into account the addition of the foreign income (GILTI) to the tax base and not the addition of the foreign property, payroll and sales to denominators of the apportionment formula that will significantly offset any additional tax revenue; and finally, the estimate was static, meaning it does not consider how taxpayers will respond to the proposed change.

DOR's significantly smaller revenue estimate may still be inflated. It is based on the taxpayers domestic apportionment factors (payroll, sales, property) only which tend to increase the amount owed. If the taxpayers were allowed to utilize an apportionment formula based on both its domestic and foreign factors, the amount owed to the Commonwealth would likely decrease even more.

In summary, the proposed tax changes to GILTI raise important questions about constitutionality, double taxation, and the overextension of Massachusetts taxing jurisdiction over foreign income. Given the modest tax revenues and complexities associated with this change, it does not make sense for lawmakers to advance changing the tax treatment of GILTI as a way to pay for transportation.

[10] *Where in the World Is Factor Representation for Foreign-Sourced Income by* Karl A. Frieden and Joseph X. Donovan, State Tax Notes, April 15, 2019.

[11] Massachusetts Budget and Policy Center referencing a study done by the Penn Wharton Budget Model (PWBM) affiliated with the University of Pennsylvania.