Where in the World Is Factor Representation For Foreign-Source Income?

by Karl A. Frieden and Joseph X. Donovan

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In this viewpoint, Frieden and Donovan discuss global intangible low-taxed income and IRC section 965 repatriated income and argue that states should allow foreign factor representation for apportionment of this income.

I. Executive Summary

State conformity actions relating to the 2017 federal tax reform legislation — the Tax Cuts and Jobs Act — have unfolded over 15 months. It appears that between one-third and one-half of the states with corporate income taxes will subject either the global intangible low-taxed income under Internal Revenue Code section 951A or the foreign-source income deemed repatriated under IRC section 965, or both, to their state income taxes.

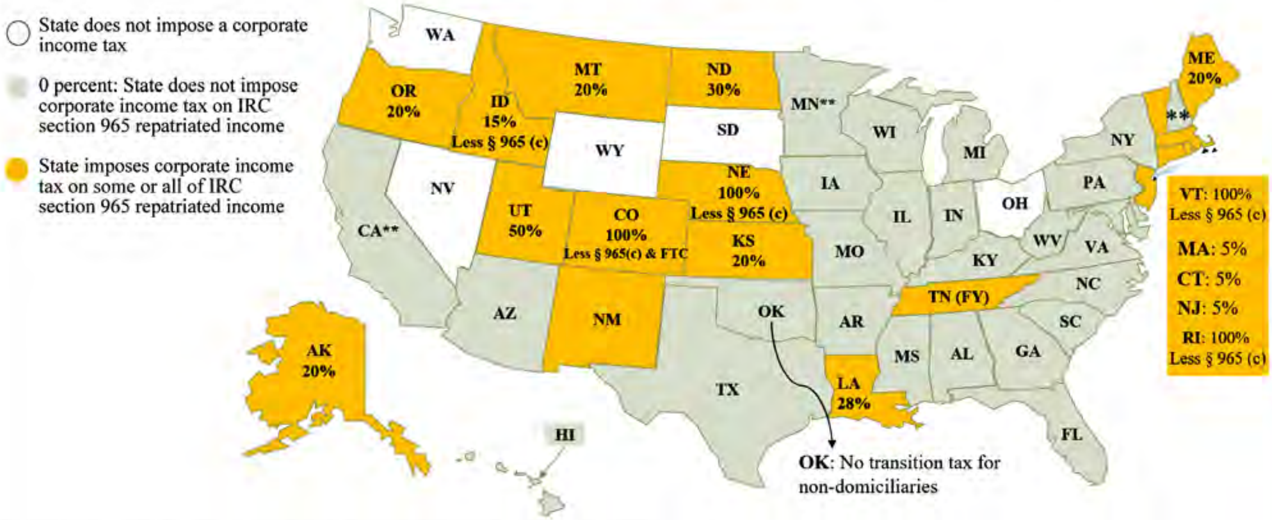
We have previously asserted that state taxation of GILTI, in particular, constitutes a vast and unwarranted expansion of state taxation of foreign-source income.[1] This article does not repeat that analysis, but rather focuses on how states that do conform to these new federal tax provisions choose to apportion such foreign-source income.

To date, nearly all attention has been focused on the state-by-state consideration of conformity to or decoupling from the new provisions. Meanwhile, a less noticed but disturbing trend has developed regarding state guidance on the other key element of the state income tax equation: apportionment.[2] States generally fall into three categories relating to the application of factor representation to GILTI or section 965 repatriated income: (1) those that allow no factor representation; (2) those that allow only the net taxable foreign-source income, and not the gross receipts of the foreign corporation, to be included in the denominator of the sales factor; or (3) states that have not provided any new guidance. For states in the last category, the likely result is the same answer as in the second category, based on the existing state default apportionment rules.

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

[2] We do not address allocation issues for foreign-source income that is attributable to foreign subsidiaries that are not unitary with the U.S. taxpayer.

Figure 1.
State Corporate Income Tax Conformity to IRC 965 Repatriated Income*



*Based generally on 80 percent or more direct corporate ownership of foreign corporations. Other rules may apply for smaller percentage ownership or personal income tax purposes.
**No conformity update but taxes a portion of foreign dividends (when distributed).
Source: Council On State Taxation.
Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Shockingly, virtually none of the states conforming to the new foreign-source income provisions have adopted the traditional factor representation used for decades in state corporate income taxation — the inclusion in the denominator of each factor of the sales (and when appropriate, property and payroll) that produced the income subject to tax. This outcome violates the long-standing principle of state income tax apportionment — that the taxpayer's taxable net income in a state is determined by multiplying the taxpayer's total net income by a ratio that consists of the taxpayer's gross receipts (and payroll and property when applicable) in the state over its gross receipts and other factors in all jurisdictions. In this article, we discuss this regrettable trend, place the states' actions in historical context, and demonstrate why this outcome both is bad public policy and likely constitutes unconstitutional discrimination against foreign commerce.

II. State Conformity With Section 965 Deemed Repatriated Income and GILTI

To date, 18 states have conformed to the section 965 repatriated income, generally by taxing 50 percent or less of such earnings (see Figure 1).[3] For federal income tax purposes, this provision effectively is a one-time tax on post-1986 accumulated but undistributed earnings of 10 percent or more owned foreign subsidiaries, deemed to have been repatriated in tax year 2017.[4] Congress's stated purpose for this provision was to move the federal income tax treatment of foreign-source income from a worldwide to a territorial system. To make this transition, Congress taxed at a reduced rate the foreign deferred earnings that under the old system would eventually have been subject to tax when

[3]This information is based on a review of state statutes and regulatory guidance. However, because some state positions are unclear or in flux, this information should be used as general guidance and not relied on for corporate income tax compliance. Moreover, this information assumes that the taxpayer is a corporation that directly owns 80 percent or more of the interests in the foreign subsidiary from which the section 965 repatriated income is derived. The eligibility for DRDs for lesser percentages of ownership differs widely among the states. In nearly all states, the deductions available to corporate taxpayers for such income do not apply to personal income taxpayers, including those who are partners in partnerships or other passthrough entities that are deemed to have section 965 repatriated income.

[4]Some fiscal-year taxpayers may have repatriated income in tax years ended after December 31, 2017.

distributed. Thus, states that conform to this provision effectively end up taxing a portion of 30 years of undistributed earnings, only from foreign and not U.S. corporations. Generally, the conforming states are the same small-population states that have taxed a portion of foreign dividends when distributed or treated a portion of subpart F income as taxable foreign dividends. Other than Connecticut, Massachusetts, and New Jersey — which tax only 5 percent of section 965 repatriated income — the other conforming states (which generally tax only 20 percent to 50 percent after applying a dividends received deduction or the section 965(c) deduction) represent less than 15 percent of the U.S. population (see Figure 1).

State corporate income tax approaches to the taxation of GILTI are far more convoluted. Essentially, under section 951A, U.S. corporations must include in their income the earnings of their foreign subsidiaries, known as controlled foreign corporations (CFCs), in excess of a 10 percent rate of return on their depreciated fixed assets used in the CFC's trade or business. IRC section 250 provides corporate taxpayers with a 50 percent deduction (reduced to 37.5 percent in 2026) for GILTI. For many U.S. multinational corporations, GILTI can amount to all or substantially all the earnings of their foreign subsidiaries, reduced by the section 250 deduction (at the federal level and in some states), and by credits for taxes paid to other countries (at the federal level).[5]

The application of GILTI, however, is significantly different at the state level than at the federal level. The calculation of GILTI is designed to include in the federal income tax base low-taxed foreign-source income — basically, income taxed in foreign countries at less than a 13.125 percent rate. To achieve this outcome, the federal government taxes GILTI at a rate of 10.5 percent (half of the federal statutory rate after the section 250 deduction reduces GILTI by 50 percent) and allows a credit for 80 percent of foreign taxes paid on such income. State corporate income tax laws, however, do not allow foreign tax credits.[6] As a result, all GILTI — from low- or high-tax countries — is subject to state corporate income tax (less the section 250 deduction if adopted) in states that conform to the GILTI provision. This disconnect between federal and state income tax rules simultaneously undermines the intent of the federal legislation to tax only low-taxed foreign-source income and constitutes a vast and unprecedented expansion of the state corporate income tax base.

Unlike section 965 repatriated income, for which most states had an existing 100 percent DRD that precluded the taxation of deemed foreign dividends as well, no such historical precedent exists for the states regarding the taxation of GILTI. Thus, because GILTI is included in federal taxable income under the TCJA, states that conformed to the IRC either automatically (rolling conformity states) or by updating to the IRC after the enactment of the TCJA (static conformity states) generally coupled to GILTI unless they proactively decoupled by legislation or regulation. About half of the states with corporate income taxes have either decoupled from GILTI or not yet conformed with the TCJA, thus maintaining their long-standing hands-off treatment of foreign-source income.

Thirteen combined reporting states have coupled or potentially coupled to GILTI,[7] while three other combined reporting states include or potentially include 10 percent to 30 percent of total GILTI in their tax bases. Also, seven separate reporting states appear to potentially couple to GILTI, but inclusion seems clearly to be constitutionally prohibited in these states.[8]

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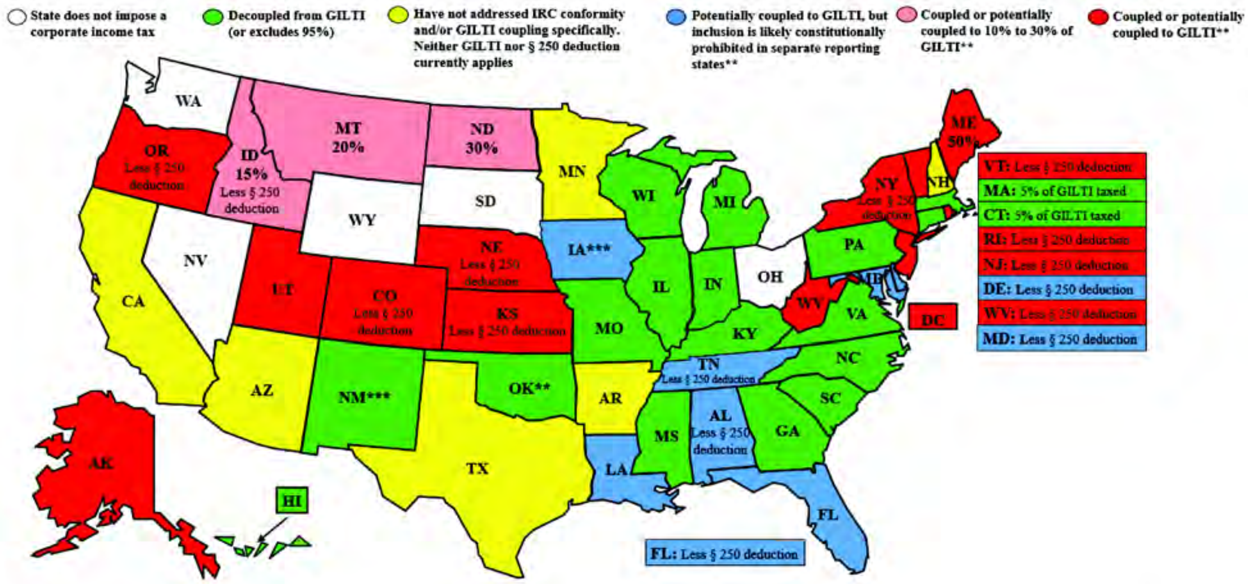
[5] Many businesses with substantial manufacturing and capital-intensive operations overseas operate with older, depreciated facilities. Other businesses operate in industries that may require limited capital investment, such as service and digital industries and financial institutions. In both instances, GILTI will include not just intangible income but most foreign-source income earned from selling physical products or providing services. For a more detailed discussion of foreign-source income included in GILTI, *see* Donovan, *supra* note 1, at 27-35.

[6] The federal GILTI calculation is further complicated by the gross-up under section 78 of FTCs allowed and by expense allocation rules regarding FTCs.

[7] GILTI is not generally referenced in state conformity statutes so there remains the possibility that some of these states will decouple from some or all GILTI by administrative guidance or future legislation.

[8] *See* Donovan, *supra* note 1, at 36-37.

Figure 2.
State Corporate Income Tax Conformity to GILTI*



*Based generally on 80 percent or more direct corporate ownership of foreign corporations. Other rules may apply for smaller percentage of ownership or PIT purposes.
**GILTI is not specifically referenced in many state conformity statutes so some states may still decouple from some or all of GILTI by administrative/legislative action.
***Iowa conformity begins in 2019. New Mexico decouples starting in 2020.
Source: Council On State Taxation.
Disclaimer: This information should be used for general guidance and not relied upon for compliance.

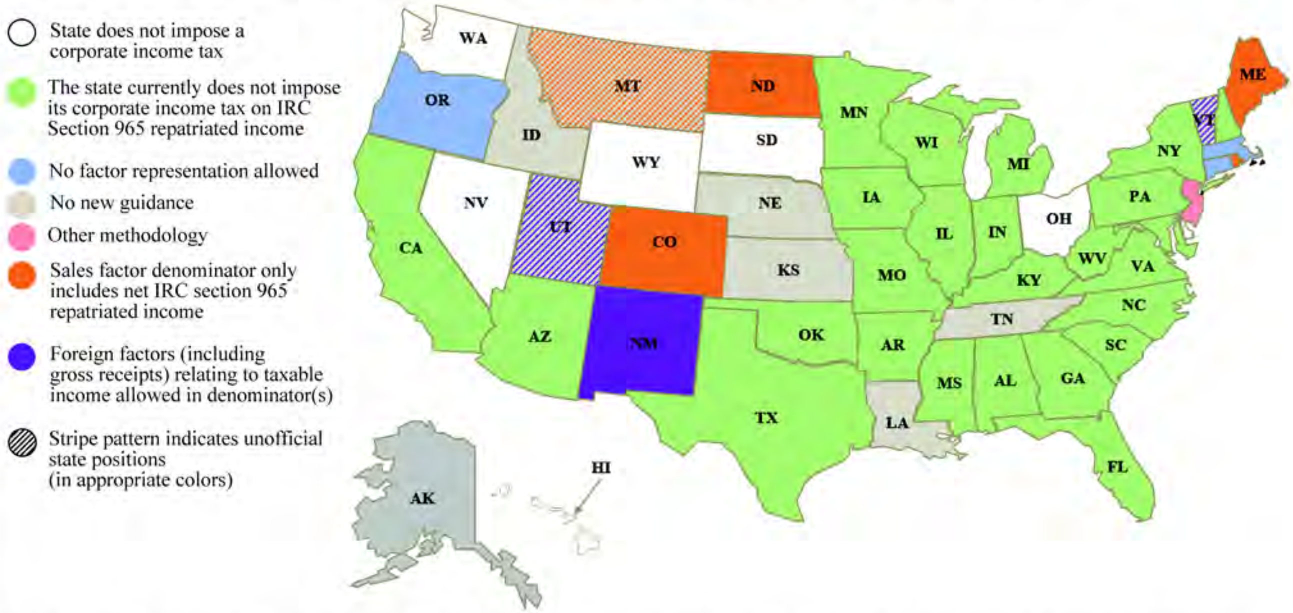
Seventeen states are decoupled from all or virtually all (two states have a 95 percent exclusion) of GILTI. Lastly, six states have not specifically addressed IRC conformity or GILTI coupling and thus neither GILTI nor the section 250 deduction currently applies.[9] About two-thirds of the states that are coupled or potentially coupled to GILTI also adopt the section 250 deduction (see Figure 2).

Despite the widespread decoupling of many states from GILTI, or nonconformity with the TCJA entirely, expansion of the tax bases in the remaining states to include GILTI represents a significant and unprecedented broadening of the historically limited state taxation of foreign-source income.[10] However, the number of states that have conformed in whole or in part to the GILTI regime probably overstates the scope of this trend. Of the 16 combined reporting states that include GILTI in their tax bases, only two — New York and New Jersey — have large populations or many major corporate headquarters. The other 15 largest states, which make up nearly three-fifths of the nation's population, have either decoupled from GILTI in whole or in part (Georgia, Illinois, Massachusetts (95 percent), Michigan, North Carolina, Pennsylvania, and Virginia); not conformed to the TCJA (Arizona, California, and Texas); do not have a corporate income tax (Ohio and Washington); or are separate reporting states that seem to be constitutionally prohibited from taxing GILTI (Florida).

[9] The statement in *supra* note 3 regarding section 965 repatriated income also applies to GILTI.

[10] Some state legislatures are still in session for 2019, so there may be additional state coupling or decoupling from GILTI during the year.

Figure 3.
IRC Section 965 Repatriated Income State Factor Representation*



*Based generally on 80 percent or more direct corporate ownership of foreign corporations. Other rules may apply for smaller percentage of ownership or PIT purposes.
Source: Council On State Taxation.
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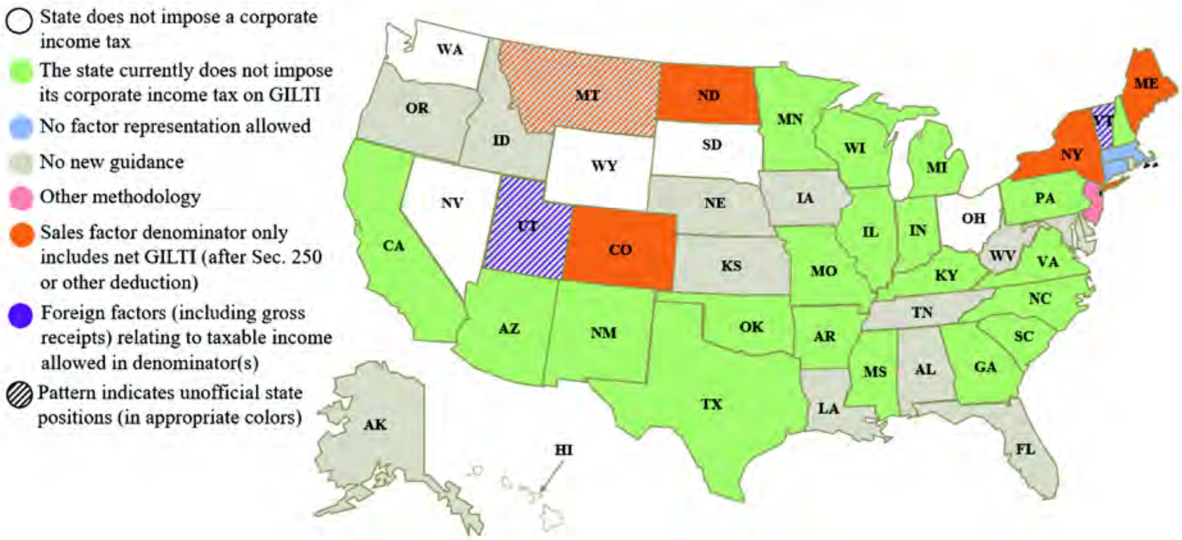
III. State Guidance on Apportionment Factors

While nearly all the attention has focused on whether a state will conform or decouple from the TCJA's international tax provisions, a less noticed but troubling trend has developed regarding state guidance on how to apportion or allocate the newly taxed foreign-source income. Those states that have determined that GILTI or section 965 repatriated income is included in their tax bases have generally fallen into three categories in terms of apportionment and factor representation: (1) allowing no factor representation; (2) allowing only the net taxable foreign-source income to be included in the denominator of the sales factor and not the gross foreign receipts of the CFC that produced the income; or (3) providing no new guidance, which likely results in the same answer as the second category based on existing default apportionment rules. Shockingly, only New Mexico has provided written guidance (two states have unofficial positions) stating that it will follow the traditional factor representation that has been used by all states for decades in apportioning multijurisdictional income, by including in the denominator the respective factors for the sales, property, or payroll of the corporation (in this case the CFCs) that produced the taxable income.

Regarding section 965 repatriated income (see Figure 3), three states (two of which include only 5 percent of such income in their tax bases) have provided guidance indicating taxpayers are not permitted any factor representation in connection with section 965 repatriated income, thus taking the position that taxpayers that recognized such income are precluded from including any of the factors of the foreign subsidiaries that produced the income in the apportionment formula. Four states have provided written guidance stating that taxpayers are allowed to include only the net section 965 income in the denominator of the sales factor. Nine states have not provided written guidance; however, two of those states (Utah and Vermont) have historically allowed taxpayers to use the foreign factors relating to the taxable foreign dividend income in the denominator of the sales factor (or other factors), and Montana

Figure 4.
GILTI State Factor Representation*



*Based generally on 80 percent or more direct corporate ownership of foreign corporations. Other rules may apply for smaller percentage of ownership or PIT purposes.
Source: Council On State Taxation.
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has unofficially indicated that taxpayers should use net section 965 income in the denominator of the sales factor. Only New Mexico has provided written guidance specifying that "a taxpayer is permitted to include an appropriate percentage of the payroll, property and sales of their foreign dividend payors [that is, the foreign subsidiaries] in determining the New Mexico Percentage of their income that is subject to tax."[11]

In Figure 4, a similar pattern emerges for the state guidance issued relating to GILTI factor representation. Two states that include only 5 percent of GILTI in the state corporate income tax base have provided guidance stating taxpayers are not permitted any factor representation. Four states have provided written guidance indicating taxpayers are allowed to include only the net GILTI amount in the sales factor denominator. New Jersey has developed a unique formula that disallows the use of the foreign factors of the foreign subsidiaries and replaces them with a contrived domestic formula based on New Jersey's share of the GDP of the states in which the taxpayer is subject to state income tax (see analysis below). The remaining 18 states that couple or potentially couple to GILTI have not provided any written guidance, although Utah and Vermont have historically, in conjunction with taxable foreign income, allowed taxpayers to use the receipts and other factors of the foreign subsidiaries in the denominator of the sales factor (and other factors), and Montana has unofficially indicated that taxpayers should use net GILTI in the denominator of the sales factor.

A. What Is the Default Rule When No New Factor Representation Guidance Has Been Provided?

As noted, to date more than two-thirds of the states that are imposing, or potentially are imposing, corporate income tax on either repatriated income or GILTI have not issued new guidance on how to apportion such income. Hopefully guidance will be forthcoming during 2019, but it is already too late for taxpayers reporting IRC section 965 repatriated income for tax years beginning in 2017. At least for taxpayers

[11] New Mexico Taxation and Revenue Department, "New Mexico Corporate Income Tax on Deferred Foreign Income Pursuant to IRC Section 965," Bulletin B300.17 (Oct. 2018) (brackets added).

in states that impose their corporate income tax on GILTI, the first tax year that is implicated begins in calendar 2018.

The absence of new state guidance, however, does not mean there are no apportionment rules to follow. A taxpayer can look to apportionment guidance previously provided by statute or regulation. Unfortunately, that guidance generally suggests that a taxpayer should apportion such foreign-source income without applying any foreign factors, and at best, include the net section 965 repatriated income or GILTI amounts that are reported to the state in the sales factor denominator.

For instance, consider a state that requires the filing of a water's-edge combined return by the members of a unitary group. Assume that the only statutory change is that the state conforms to the IRC after enactment of the TCJA and thus picks up GILTI as part of the federal taxable income base of the taxpayer that is a member of the water's-edge group. If no other statutory changes are made to the apportionment formula, then there is likely no provision that would allow the taxpayer to include in the denominator of its factors the foreign sales or other factors of the foreign subsidiary that generated the income. Because the CFC would not be deemed part of the water's-edge group, at best, the taxpayer would include the net GILTI amount in the factor, because that may be considered a receipt to the taxpayer.[12] The reason for this outcome is that a water's-edge combined return, by definition, generally includes only the income and factors of taxpayers that have nexus with the taxing jurisdiction and any other members of the unitary group that are incorporated in the United States.[13]

This anomalous result occurs because of the hybrid nature of GILTI at the federal level: the income is generated by the U.S. taxpayer's foreign subsidiaries (the CFCs), but because those entities are not part of the federal consolidated group of which the taxpayer is a member, the income is deemed for federal income tax purposes to be the U.S. taxpayer's. Thus, it is included in a conforming state's corporate income tax base because of the linkage between the taxpayer's state and federal taxable income, but there is nothing (without statutory or regulatory guidance) that brings the CFC's factors into the apportionment formula. The federal government circumvents this problem and the potential for double taxation through the TCJA statutory provision that allows 80 percent of the FTCs generated by the CFCs to reduce the U.S. taxpayer's tax on GILTI. But because no states conform to the allowance for FTCs, no adjustment occurs at the state level.

B. The States' Approach to Factor Representation for New Categories of Foreign Source Income

If a state that does not provide factor representation for foreign-source income offers full factor representation for similarly situated domestic income in a combined return, it clearly treats foreign-source income unfairly from a public policy perspective. This approach also discriminates against an investment in a foreign subsidiary to the benefit of a domestic subsidiary. Such discrimination clearly violates the U.S. Constitution's foreign commerce clause (see

[12]Taxpayers familiar with formulary apportionment rules are likely to assert that the proper statutory and constitutional interpretation of factor representation relating the newly added GILTI provisions and section 965 repatriated income is to include both the income and the factors of the CFC that produced the income in calculating taxable income. Depending on the state, however, the statutory language may not be helpful. Other taxpayers may consider the impact distortive and request alternative apportionment in some states. However, alternative apportionment is intended for unusual or extraordinary situations, and not as a solution for a common occurrence among taxpayers with foreign-source income.

[13]To the extent a water's-edge statute includes some foreign-source income, as for example with states that include some CFC income in the tax base such as subpart F income or tax haven income, there are typically specific and not open-ended provisions that provide for foreign factor representation only for those types of income previously addressed in the statute. *See* Multistate Tax Commission, "Proposed Model Statute for Combined Reporting," section 5A, as amended by the MTC July 29, 2011; *see also, e.g.*, Idaho Code section 63-3027B and Mont. Code. Ann. section 15-31-322. The result may be slightly different for taxpayers with section 965 repatriated income because many states have provisions addressing factor representation relating to foreign dividends. But even here, as is discussed more below, only a small number of states that taxed foreign dividends allowed the full use of the CFC's factors in the denominator of the taxpayer's apportionment factors.

Section IV). It is well known that adding the income of a non-nexus unitary subsidiary in the tax base taken by itself increases the taxpayer's potential tax liability, but states have long recognized that the effect of increasing the base is fairly offset by adding the sales (and when relevant, property and payroll factors) of these non-nexus domestic entities to the denominators of the apportionment formula of the combined group. Whether the inclusion helps or hurts the taxpayer depends on the facts, but factor representation is required to assure that double taxation does not occur for the combined group's non-nexus members.

In limited situations, when a state taxes only 5 percent of section 965 repatriated income or GILTI (e.g., Massachusetts and Connecticut), this outcome might be justified on the notion that the 5 percent inclusion is in lieu of the disallowance of expenses attributed to income that is not subject to tax — the foreign-source income.[14] But that is an exceptional circumstance, and that logic should not apply to other states that generally tax between 20 percent and 100 percent of these categories of foreign-source income.

Including net taxable income in the denominator of the sales factor is less onerous than excluding all foreign factors, but still can be highly unfair and discriminatory. For example, consider a taxpayer filing a corporate income tax return in a combined reporting jurisdiction that apportions income using only a single sales factor, and for which the net GILTI accounts for 50 percent of its total taxable income. Assume that: (1) the taxpayer has $100 million of domestic income and $100 million of GILTI (after the application of the IRC section 250 deduction); (2) both domestic and foreign sales are five times its domestic and foreign-sourced taxable income; and (3) the taxpayer has $50 million in sales in the state (a 10 percent sales factor before consideration of the foreign income and factors). If the taxpayer could include the $500 million of foreign sales that contributed to the taxable GILTI amount in the denominator of its sales factor, its apportionment ratio would drop from 10 percent to 5 percent. If the taxpayer is allowed to include only the net GILTI in the denominator of its sales factor, its in-state apportionment ratio would drop only to 8.3 percent. Thus, the taxpayer's apportionment ratio and taxable income after apportionment would be more than 66 percent more if it is required to include its taxable GILTI amount, and not the foreign receipts that contributed to the GILTI, in the sales factor denominator. One can easily imagine scenarios for taxpayers in lower-profit-margin industries where the difference between includible taxable GILTI and gross receipts is even more significant. Because this outcome is more punitive than what applies to a non-nexus domestic subsidiary that is required to include its income and factors in a taxpayer's water's-edge combined group, such disparate treatment would constitute facial discrimination against foreign commerce in favor of domestic commerce.

While including only the net taxable foreign income and not foreign receipts in the sales factor denominator is patently discriminatory to taxpayers with foreign-source income, following this approach at least indirectly includes some portion of foreign sales in the sales factor denominator. New Jersey has come up with an even more onerous apportionment formula making it the poster child for the trend to treat taxpayers with foreign-source income in an unfair and discriminatory manner. For GILTI, instead of allowing the taxpayer to include in the sales factor denominator the foreign receipts that contributed to GILTI in the year at issue, the Tax Division adopted an entirely novel apportionment method using the ratio of New Jersey's GDP over the total GDP of every state where the taxpayer has economic nexus. This apportionment method has nothing to do with either the production of GILTI or the taxpayer's presence in New Jersey. The effect of this nonsensical and arbitrary approach is to deny the taxpayer the inclusion in the

[14] Connecticut provides a 100 percent DRD for section 965 repatriated income and GILTI, but then requires an addback equal to 5 percent of the gross amount of GILTI and 5 percent of the repatriated income to reflect the "addback [of] its expenses that relate to dividend income". Connecticut Department of Revenue Services, "Treatment of Intangible Low-Taxed Income for Connecticut Corporation Business Tax Purposes," SN2018(7) (July 20, 2018); and Connecticut Department of Revenue Services, "Office of the Commissioner Guidance Regarding the Connecticut Treatment of the Federal Repatriation Transition Tax under IRC Sec. 965," OCG-4 (May 11, 2018).

denominator of the New Jersey sales factor of any of the foreign receipts that contribute to the production of GILTI in the first place.[15]

To demonstrate how distortive it is for income earned globally to assign a taxpayer's apportionment factors based on a state's relative economic size compared with other states, consider this example: The Company A domestic group has 50 percent of its sales and income outside the United States and only 1 percent of its domestic sales in New Jersey. The Company B domestic group has 10 percent of its sales and income outside the United States and 10 percent of its domestic sales in New Jersey. Assuming both companies have operations in all 50 states, their apportionment percentage under the New Jersey rule would be an identical 3.1 percent, regardless of where or how GILTI was earned or how much of a share that income contributed to the taxpayer's overall income. If foreign factors concerning the production of the foreign-source income were used instead, Company A's apportionment ratio in New Jersey would be about 1/18th of that of Company B (assuming the same 5-to-1 ratio of domestic and foreign sales to income). Remarkably, the New Jersey formula manages to discriminate against both foreign commerce and interstate commerce in favor of in-state commerce.

The Division of Taxation is certainly correct that GILTI must be apportioned to satisfy statutory and constitutional requirements. But its published guidance inappropriately adopts a purely domestic factor representation method for foreign-source income that has no apparent connection to each affected taxpayer's actual in-state operations. This approach not only represents bad public policy, but also is likely unconstitutional, as it violates the U.S. Supreme Court's current interpretation of the commerce clause requirements: (1) that the taxpayer's liability be rationally related to its business in the state; (2) that foreign commerce not be discriminated against in favor of domestic commerce; and (3) that apportionment be fair.

IV. Guidance Contradicts Long-Standing State Apportionment Rules

What is most striking about the status of state guidance for apportioning GILTI and section 965 income is how completely out of sync it is with the long-established methods and objectives the states have used to apportion taxable net income earned in the ordinary course of business operations. For decades, the foundation of state apportionment has been using factors that are related to the production of the income subject to tax. As Jerome and Walter Hellerstein wrote in their seminal treatise on state taxation: "The factors that are employed to apportion income among the states should reflect the factors that produce the income being apportioned. This virtually axiomatic proposition is also a principle of constitutional law."[16] This principle was enunciated in *Container Corp.* in the early 1980s, when the Court wrote, "The factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[17]

The key to this principle is the use of factors of production — initially property, payroll, and sales, but increasingly in recent years, just sales — to apportion income. The sales factor entails using the gross receipts that contributed to the production of the income, and not the net income itself, to form the basis of the apportionment ratio. For example, following this basic premise for GILTI, the gross receipts relating to the production of the income would be the receipts of the foreign subsidiaries that contributed to the generation of the current-year GILTI, and not the net amount of the GILTI. Similarly, applying this principle with section 965 income, the factor should reflect the receipts of the foreign subsidiaries over the years they generated the previously untaxed foreign earnings and profits that are the basis for determining the income, and

[15] The division acknowledges this result in its bulletin explaining the rule, stating, "Taxpayers may not look through to the underlying sales when determining how to allocate GILTI." New Jersey Division of Taxation, "Tax Conformity to IRC Sec. 951A (GILTI) and IRC Sec. 250 (FDII)," TB-85(R) (Dec. 24, 2018). It is worth noting the application of the New Jersey formula to Foreign Derived Intangible Income (FDII) is just as illogical.

[16] Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, Part IV 9.15.

[17] *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

not the net amount of the repatriated income itself.

This basic principle of state apportionment has been consistently followed by the states for decades and regularly endorsed by the U.S. Supreme Court and every state court that has addressed the issue.[18] To be sure, some states have used different filing methods to identify the taxpayers and members of their unitary group (separate reporting, water's-edge combination, and elective worldwide combination). States have differed in the weighting of factors used in apportionment formulas (three-factor equally weighted property, payroll, and sales formulas; single-sales-factor formulas; and other combinations). States have varied in their sourcing rules, especially regarding the sales factor (market/destination vs. cost of performance). Finally, the states have shifted among these formulas, with a significant movement toward single-sales-factor apportionment and destination sourcing in the last two decades. But in all cases, the underlying basis of the factors that are included in the formulas — at least regarding apportioning income earned in the ordinary course of trade or business — has, with few exceptions, been the property, payroll, or sales that are related to the production of the income that is included in the corporate income tax base.

For instance, in a water's-edge combined reporting jurisdiction, the taxpayers generally are the members of the unitary group that have nexus and are doing business in the state. The tax base includes the taxpayers' income and the income of any other non-nexus members of the unitary business that are incorporated in the United States. This approach is mirrored in the apportionment formula with the inclusion of all the apportionment factors of the taxpayers and non-nexus members of the unitary business that are incorporated in the United States.[19] It is aberrational for states to tax income earned in the ordinary course of trade or business with apportionment factors that reflect, at least in the sales factor, net income rather than gross receipts.

A. The Foreign Dividend Exception

There has been one notable exception to the nearly universal rule allowing taxpayers to use the factors, including the gross receipts of the entity responsible for the production of income, in the apportionment factors including the sales factor.[20] This exception has occurred when some states, particularly those that tax foreign dividends (or subpart F income), have allowed no factor representation, while others have allowed only the taxable dividends to be included in the sales factor denominator.[21]

But the importance of this exception should not be overstated. First, the circumscribed factor representation has not applied to the current trade or business income of foreign subsidiaries like that constituted by GILTI, or past trade or business earnings of foreign subsidiaries that are the base of the deemed section 965 repatriated income, but only to dividend income that is actually distributed to the taxpayer or the limited amount of passive income that was taxed as subpart F income. Second, the minority of states that historically taxed foreign dividends typically provided substantial DRDs that resulted in only a modest percentage of the dividends (even when distributed) actually being taxed. Third, this limitation of apportionment factors to exclude foreign factors when taxing foreign-source income or limiting the sales factor to the net distributed foreign dividend is of dubious

[18] *See, e.g., Container Corp.*, 463 U.S. 159; and *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980).

[19] *See generally* MTC, *supra* note 13, section 5A. Even when a water's-edge combined reporting group is required to include some income of foreign subsidiaries, the foreign factors associated with such income are included in the apportionment formula. *See* MTC inclusion of the income and related apportionment factors of foreign subsidiaries with tax haven income and 80/20 income. *Id.*, section 5A. California includes the income and related factors of foreign corporations if the average of the corporation's U.S. property, payroll, and sales factors is 20 percent or more. Cal. Rev. and Tax. Code section 25110(a)(1)(B).

[20] There are other exceptions to the traditional apportionment rules for business corporations, but these generally involve "unique and non-recurring" transactions such as occasional sales of substantial fixed assets or other property, or atypical transactions such as interest from intangible assets held in connection with a treasury function. *See generally* Cal. Code Regs. section 25137.

[21] *See generally* the states that tax foreign dividends in Figure 1.

constitutional validity, and will certainly be challenged in the next few years for states that apply a similar concept to both repatriated income and GILTI.[22]

Moreover, even for the state taxation of foreign dividend income, the position of the states regarding the appropriate apportionment formulas to use has been split. Many states adopted variations of the "Detroit Formula," so named because it was developed for Detroit's income tax in the late 1970s.[23] The Detroit Formula provides factor representation for foreign dividend income by requiring the inclusion "in the denominators of the property, payroll, and sales factors the property, payroll, and sales of the taxpayer's controlled foreign subsidiaries, in the same ratio that the net dividends received from such subsidiaries bears [sic] to each subsidiary's entire net profits, but not to exceed 100 percent thereof."[24]

Several states, including New Hampshire, New Mexico, Utah, and Vermont have adopted variations of the Detroit Formula in conjunction with their taxation of foreign dividends. The formula is consistent with the historical norm of allowing the factors — in this case the foreign factors — that produced the taxable income to be included in the apportionment formula. The one deviation from the traditional method is that the factors are sometimes capped at 100 percent of current year's E&P given the unique circumstances of distributed foreign dividends that can represent multiple years of E&P.

B. Clear Precedents for How to Appropriately and Constitutionally Apportion Foreign-Source Income

The truth is that the states do not have to scramble to adopt some newfangled apportionment criteria to apply to repatriated income and GILTI. In addition to the Detroit Formula, the Multistate Tax Commission has a model statute that addresses factor representation for different categories of foreign-source income in conjunction with the filing of a water's-edge combined return.[25] The MTC model combined reporting statute addresses several discrete categories of foreign-source income, including subpart F income earned by foreign subsidiaries, income from 80/20 corporations that have 20 percent or more of their factors in the United States, and income from foreign subsidiaries that have income in designated tax haven countries. In each instance requiring foreign income inclusion, the MTC model statute also requires inclusion in the taxpayer's apportionment calculation of "the apportionment factors related to that income."[26] If adopted by a state for GILTI or section 965 income purposes, this language would require the inclusion of the factors of the CFC that generated the income in the denominator of the apportionment factor.

Finally, several states that require water's-edge combined reports allow taxpayers to elect to file a worldwide combined return. In such cases, the rule is well established that because the income of the foreign subsidiaries is included in the worldwide unitary group's income tax base, the factors of those same foreign subsidiaries are included in determining that group's apportionment to the state as well. The MTC's model statute relating to the filing of worldwide combined returns states: "A taxpayer engaged in a

[22] There are many explanations for the limited reported litigation and court decisions addressing apportionment formulas as applied to foreign dividends or subpart F income that did not provide full factor representation. These include: (1) There is significantly less incentive to litigate when lower dollar amounts are at stake. The tax impact of these rules was lessened because many corporations did not repatriate foreign earnings; only a modest portion of the foreign dividends were subject to tax; subpart F income was immaterial to most corporations; and most of these rules applied in smaller states with few large corporations. (2) These cases typically involved dividend income, not current-year trade or business income (or 30 years of deemed repatriated trade or business earnings) in which the pro-taxpayer legal arguments are more straightforward. (3) In some instances, dividend income was treated as allocable nonbusiness income and was only an issue in the domiciliary state. (4) Many taxpayers entered into settlements with taxing authorities or used alternative apportionment to avoid litigation. (5) Several of the affected states allowed Detroit Formula variations that provided more reasonable factor representation.

[23] *See* Hellerstein and Hellerstein, *supra* note 16, para. 9.15[2][a]; and Lynn A. Gandhi, "Rev Your Engines — The Detroit Formula, Time for a Revival?" *State Tax Notes*, Feb. 11, 2019, p. 467.

[24] Hellerstein and Hellerstein, *supra* note 16.

[25] MTC, *supra* note 13, section 5A.

[26] *Id.*

unitary business with one or more corporations shall file a combined report which includes the income . . . and apportionment factors . . . of all corporations that are members of the unitary business."[27] Under this language, there is no limitation that excludes the factors of the unitary foreign subsidiaries whose income is included in the tax base.

In terms of the taxation of GILTI or repatriated income that might represent less than all of a foreign subsidiary's income in a given year, these principles can easily be adapted by limiting the foreign factors to be included in the apportionment formula's denominator to the ratio of the includible taxable foreign income over total CFC income. For example, a state can reduce the factors to be included to the extent the amount of GILTI is less than the overall income of the CFCs, because the GILTI calculation allows a reduction based on a normal (10 percent) rate of return on the tangible assets of the CFCs or because the state adopts the section 250 deduction. This approach is consistent with how foreign apportionment factors are adjusted in connection with the Detroit Formula when distributed foreign dividends are less than 100 percent of current year E&P. It is also consistent with the federal computation of FTCs associated with GILTI, which are discounted in such circumstances to reflect the ratio of the GILTI amount over the CFC's total income.[28]

There are certainly complexities associated with making adjustments to apportionment factors because all the foreign-source income in a given year is not included in the tax base, but nothing out of the ordinary that cannot be addressed with some regulatory or tax form guidance.[29] Unfortunately, despite the availability of clear precedent for providing appropriate factor representation in relation to GILTI and repatriated income, the states are contorting themselves to try to limit factor representation and are providing flimsy explanations for their actions. The near-universal state divergence from allowing taxpayers to use the foreign factors associated with the foreign-source income that is included in the corporate tax bases of some states through TCJA conformity seems to reflect a belief that states have nearly unlimited latitude in designing apportionment formulas. This belief, in turn, arises from several sources, including:

- a flawed understanding of the foreign commerce clause;
- an incorrect conclusion that *Kraft*[30] is limited to foreign dividends and does not apply to other foreign-source income;
- a misperception that all or most of this new foreign-source income is actually displaced domestic income;
- an assertion that adoption of section 250's 50 percent reduction in taxable GILTI frees the states to manipulate the sales factor rule however they choose; and
- a blatant attempt to maximize state revenue regardless of the underlying policy or constitutional implications.

It is to these justifications by the states for contravening decades of universally accepted state apportionment factor rules that we now turn our attention.

V. Critique of States' Theories for Circumventing Traditional Apportionment Methods

In addition to appealing to fundamental fairness, our argument for using appropriate factor representation in the taxation of GILTI and repatriated income rests on two bedrock constitutional rules under the commerce clause. First, it is "virtually per se invalid" for a state to tax income from foreign sources more harshly

[27] *Id.*, section 2A. The MTC model statute and some states such as California achieve the outcome of allowing but not mandating worldwide combined reporting by using worldwide combined returns as their default method, but then allowing taxpayers to elect to file water's-edge combined returns.

[28] *See* IRC section 960(d). With GILTI, a state would need to address other issues such as backing out the section 78 gross-up for FTCs and allowing for factor representation for income included from tiered CFCs. For an example of how this calculation might work, see Donovan, *supra* note 1, at 324, Chart 4.

[29] New Mexico recognized this complexity regarding apportionment factors used in connection with section 965 deemed repatriated income by offering taxpayers the choice between using the CFCs' foreign factors or by excluding an additional 20 percent of their net section 965 deferred foreign income from their taxable income. *See* New Mexico Taxation and Revenue Department, *supra* note 11.

[30] *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992).

than income from domestic sources.[31] And second, "the linchpin of apportionability is the unitary business principle."[32]

Theory: But *Kraft* Is Dead!

In an earlier article, we explained why *Kraft* [33] prohibits including GILTI and section 965 repatriated income in the tax bases of separate reporting states entirely, and in the tax base of combined reporting states unless appropriate factor representation is part of the picture.[34] In response, Helen Hecht, MTC general counsel, has posited that perhaps a majority of the current justices on the Supreme Court no longer believes in *Kraft*, and that the case is limited in its application to the taxation of foreign dividends by a separate-reporting state.[35] Regarding the first point, we think it is beyond speculative to suggest that the Court no longer is enamored with the anti-discrimination principle that it announced in *Kraft*.[36] And as more conservative and textualist justices join the Court, there may be growing support for the view most prominently supported by Justice Clarence Thomas, that there is no such thing as the dormant commerce clause.[37] However, no dispassionate observer could seriously suggest that a majority of the Court supports that rather radical proposition, or that abandonment of the dormant commerce clause is nigh. Absent such a sea change in commerce clause jurisprudence, a prediction that *Kraft* will be abandoned amounts to a prediction that the Court will conclude that discrimination against foreign commerce is perfectly fine. That seems contrary to over 200 years of constitutional law prohibiting discriminatory state taxation of both interstate and foreign commerce.

Theory: The States Have Wide Latitude in Apportionment

In their attack on the breadth of *Kraft*, both Hecht and her MTC colleague, Brian Hamer, suggest that we should look to the line of cases that demonstrate the Court's reluctance to impose apportionment methods on the states. Hamer cites the dictum that the "various means that have been used by states to assign income 'are imperfect proxies for an ideal that is not only difficult to achieve in practice, but also difficult to describe in theory.'"[38] The Court, in making this point, was articulating the truism that there is no gold standard by which to judge the appropriateness of a state's sourcing method. Without such a standard, it would be foolish and contradictory with the principles of federalism for the Court to pick a standard and mandate it for all states. Accordingly, the Court clearly can live with a great deal of variation in apportionment strategies, and with the consequence that more or less than 100 percent of a corporation's profits may be attributed to the states in which it does business. What it can't live with, as far as we know from the case law, is a regime that discriminates against income from foreign sources. If the point is pressed, we have reason to believe that courts, following the logic of *Oregon Waste*, will focus on discrimination and not undue burden, distortion, or balancing tests in assessing the constitutional adequacy of state conformity to GILTI and repatriated income provisions.

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[31] *See Oregon Waste Systems Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93 (1994), in which the Court invalidated an Oregon regime imposing a higher surcharge on disposal of waste generated outside the state than waste generated in the state. In such cases of discrimination against interstate commerce, the Court wrote that the state's burden of justification "is so heavy that 'facial discrimination by itself may be a fatal defect.'" We thank Steve Wlodychak of EY for his insights regarding *Oregon Waste* and burden of proof in commerce clause cases dealing with state tax discrimination, in contrast with those addressing undue burden or fair apportionment. Interestingly, Justice Clarence Thomas — no champion of the Court's dormant commerce clause jurisprudence — delivered the Court's opinion in *Oregon Waste*.

[32] *Mobil Oil*, 445 U.S. 425, 439.

[33] 505 U.S. 71.

[34] *See* Donovan, *supra* note 1, at 26.

[35] *See* Amy Hamilton, "All the Talk: New Jersey's Unique Method for Apportioning GILTI," *State Tax Notes*, Feb. 25, 2019, p. 717.

[36] In fact, the ink is barely dry on the Court's decision in *Dawson v. Steager*, 586 U.S. ___ (2019), wherein it signaled how categorical its jurisprudence can be it when it comes to state tax discrimination. Justice Neil Gorsuch, writing for a unanimous Court, enforced the requirement under the intergovernmental immunities doctrine and 4 U.S.C. section 111 that West Virginia treat state and federal pension recipients equally, rejecting the state's argument that the state pension exemption was valid because it covered only a small number of retirees and was intended to benefit them, rather than harm federal retirees.

[37] Recall that Justice Antonin Scalia, in a dissent in which he was joined by Thomas, characterized the doctrine as "a judicial fraud" as recently as 2015. *See Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. ___, 135 S. Ct. 1787, 1808 (2015).

[38] Brian Hamer, "States Should Embrace GILTI or Pursue an Alternative Path to Fairness," *State Tax Notes*, Feb. 11, 2019, p. 475, citing at 478 *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 303 (1994). A similar point is made by Darien Shanske and David Gamage, when they write about "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-taking." Shanske and Gamage, "Why States Can Tax the GILTI," *State Tax Notes*, Mar. 18, 2019, p. 967.

Theory: Only Dividends, Narrowly Construed, Are Covered by *Kraft*

Every case has a context, which can be important, but we have learned from the language in many legal opinions that there is such a thing as "a distinction without a difference." The distinction between dividends in the technical sense, which is to say distributions out of E&P, and income of a foreign subsidiary that is deemed the income of its U.S. parent regardless of E&P, is such a distinction. No matter how one looks at it, both GILTI and section 965 repatriated income represent income from foreign sources. While the federal government can discriminate against such income in favor of income from domestic sources (subject of course to our treaty obligations), under the U.S. Constitution as interpreted by the Court, the states simply cannot.

Let us suppose that at the time *Kraft* was decided Iowa piggybacked on federal rules that were different from those that were actually in effect. In this new scenario, domestic dividends were exempt as were actual distributions out of the E&P of a foreign subsidiary, but a mechanism was put in place to sweep the current earnings of the foreign subsidiary into the tax base of its parent. Would the Court permit this result, with its obvious discriminatory consequences, on the grounds that the deemed payment from the foreign subsidiary was not a dividend and therefore not equivalent to the exempt payment received from a domestic subsidiary? We think not.

The Massachusetts Supreme Judicial Court some years ago addressed a similar question, in the context of subpart F income and section 78 gross-up, in *Dow Chemical Co. v. Commissioner of Revenue*.[39] There the court held that these categories of income, deemed dividends under the IRC, were includible in Massachusetts income but eligible for the Massachusetts DRD. Its conclusion was based on principles of statutory construction, informed by a presumed legislative purpose to prevent multiple taxation. Importantly, it did not matter to the court that the multiple taxation comprised Massachusetts taxation on the one hand and a tax imposed by a foreign sovereign on the other. The court wrote:

> Foreign subsidiaries are in fact subject to tax in the countries in which they are incorporated. The [Massachusetts] corporate excise, by allowing a deduction for dividends from these subsidiaries and thus preventing the possibility of triple taxation [by the home country, the United States, and Massachusetts], performs the same general function in the State scheme as does the foreign tax credit in the Federal scheme. We have no warrant for destroying this symmetry by arbitrarily ruling foreign dividends out of the dividends category altogether.[40]

In a footnote, the court explained why it analyzed both the question whether subpart F income was income for Massachusetts purposes, and whether such income should qualify for the DRD. In doing so, it showed a great sensitivity to the interplay between income inclusion and factor representation, writing:

> The State tax consequences to Dow would be the same whether Subpart F income were held not income, or income but subject to deduction as dividend. It is thought important to deal with the question whether it is income in order, first, to conform to the analytics of the tax system, and, second, to make it clear that no constitutional limit is approached (so long as taxable net income is fairly apportioned).[41]

[39] *Dow Chemical Co. v. Commissioner of Revenue*, 378 Mass. 254 (1979).

[40] *Id.* at 269 (citation omitted).

[41] *Id.* at 272, n.20. The court also cited a Vermont Supreme Court opinion for the proposition that if section 78 gross-up was to be included in income in the absence of a DRD "the apportionment formula applied to the taxpayer must be modified." *Id.* at 276, citing *F.W. Woolworth Co. v. Commissioner of Taxes*, 130 Vt. 544, 556-557 (1972).

Theory: Taxation of Foreign-Source Income Without Factor Representation and Domestic Combination Are 'Rough Justice' Equivalents

We continue to hear that the *Kraft* principle prohibiting the discriminatory taxation of foreign-source income, even if it remains applicable for separate reporting states, has no bearing on the ability of combined reporting states to subject GILTI and repatriated income to tax.[42] This argument is based on a misreading of the rather infamous footnote 23 in *Kraft*, the same misreading that led two courts in combined reporting states — in *In re Morton-Thiokol Inc.* [43] and *E.I. du Pont de Nemours* [44] — to allow including foreign dividends in the state tax base without factor representation. Those courts simply did not appreciate that including a domestic non-nexus subsidiary in a unitary group can either increase or decrease the tax that would otherwise be paid, nor that the inclusion of out-of-state denominators of such a subsidiary in the computation reduces the tax on the rest of the unitary group. In contrast, including GILTI or repatriated income without factor representation inevitably increases the tax on the group.

The courts in *Morton-Thiokol* and *du Pont* accepted the argument that domestic combination of a non-nexus affiliate represents a rough justice equivalent to inclusion of foreign earnings in the base. But in cases of facial discrimination, rough justice is not good enough if it leads systematically to a higher tax on foreign operations than on domestic operations. In *Oregon Waste*, decided shortly after *Kraft,* Thomas addressed this question in the context of deciding whether Oregon's higher fee for disposing of waste generated out of state was constitutional because it was part of a compensatory tax regime, like sales and use taxes taken together. Thomas wrote:

> Though our cases sometimes discuss the concept of the compensatory tax as if it were a doctrine unto itself, it is merely a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means. . . . Under that doctrine, a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and "substantially similar" tax on intrastate commerce does not offend the negative Commerce Clause.
>
> To justify a charge on interstate commerce as a compensatory tax, a State must, as a threshold matter, "identif[y] the [intrastate tax] burden for which the State is attempting to compensate." Once that burden has been identified, the tax on interstate commerce must be shown roughly to approximate — but not exceed — the amount of the tax on intrastate commerce.[45]

Just as in *Oregon Waste,* the taxation of GILTI and repatriated income (without appropriate factor representation) involves facial discrimination. Accordingly, any proposed solution that is offered must give rise to a system under which the tax that is imposed, however it is calculated, does not exceed the tax that would be imposed for domestic income.[46]

Theory: Time to Redefine 'Income From Foreign Commerce'

We have heard it argued that states need not worry about a constitutional challenge to the inadequacy of factor representation in connection with taxation of GILTI and sometimes section 965 repatriated income because these two income items do not really comprise income from foreign commerce, or in the main they do not.[47] But for the courts to accept this premise as one having

[42] *See* remarks of Helen Hecht quoted in Hamilton, *supra* note 35.

[43] *In re Morton-Thiokol Inc.*, 254 Kan. 23 (1993).

[44] *E.I. du Pont de Nemours and Co. v. State Tax Assessor*, 675 A.2d 82 (Maine 1996).

[45] *Oregon Waste*, 511 U.S. at 103 (internal citations omitted, brackets original).

[46] *See* Donovan, *supra* note 1, for examples intended to demonstrate numerically the logical flaws in *Morton-Thiokol* and *du Pont*.

[47] For this critique as applied to GILTI, see Lee A. Sheppard, "Is Taxing GILTI Constitutional?" *State Tax Notes*, July 30, 2018, p. 439; Hamer, *supra* note 38; and Shanske and Gamage, *supra* note 38, at 969-970.

constitutional dimensions, they would have to throw onto the trash heap the fundamental concept of arm's-length pricing that has undergirded the entire system of international taxation under U.S. law since at least World War II. If one were designing from a blank slate a system for assigning the profits of a multinational enterprise to the jurisdictions in which it operates, it might differ greatly from the system that we have had in place for generations. But the structure of our law — and that of most developed economies — is based on geographic accounting of income that is driven by where assets, both tangible and intangible, are situated in the corporate structure, with the liberal ability to shift risk contractually, policed only by the overriding principle that related corporations must deal with each other in the allocation of profits as if they were unrelated.

The states may argue that this system has worked poorly and has permitted multinational corporations to engage in base erosion and profit shifting activities. To a certain extent this may be true. But it is a long leap from adopting this position to convincing the U.S. Supreme Court that there is no discrimination against foreign-source income here, because what we have been calling foreign-source income since World War II we now consider to be just displaced domestic income.[48]

Of course, there is little serious debate over whether repatriated income is entirely or largely foreign-source income. After all, this income represents an acceleration of the taxation (albeit at reduced rates) of 30 years of foreign-source income that under the previous federal tax regime had been taxed only on a deferred basis when dividends were paid to U.S. taxpayers. There is a more heated discussion about GILTI, with some saying it constitutes, in large part, displaced domestic income. However, the argument that GILTI was intended primarily or wholly to counter base erosion is vastly oversimplified. A confluence of factors contributed to the enactment of GILTI, and recapturing income that may have escaped U.S. taxation through profit shifting was just one of them. Another factor was a reluctance to completely abandon worldwide taxation of U.S. corporations, and thus a quasi-territorial approach was adopted that included a global minimum tax on foreign earnings through GILTI. There was also an effort to favor domestic commerce over foreign commerce that led to the enactment of the foreign-derived intangible income deduction that provided a carrot to encourage companies to maintain intangibles and other factors of production in the United States and complemented the stick component of GILTI.

Another key goal of GILTI was to raise revenue to offset the significant cost of lowering the federal corporate income tax rate from 35 percent to 21 percent. Over the first 10 years of federal tax reform, Congress is raising $324 billion from the international tax reform provisions (including $112 billion from the GILTI provision alone) to help pay for $654 billion in other business tax cuts.[49] A strong indication that GILTI had a minimum tax and revenue-raising element to it, and not just a focus on base erosion, is that the target of 13.125 percent for low-taxed income in 2018 is arbitrarily changed to 16.406 percent in 2026 under the TCJA, resulting in much higher revenue gains in later years.[50]

Moreover, whatever the federal goals for GILTI, the practical outcome at the state level is radically different. At the federal level, GILTI is designed to include in the federal income tax base low-taxed foreign-source income — pegged initially at income taxed in foreign countries at less than a 13.125 percent rate. The federal mechanism for achieving this result is to impose a tax rate of 10.5 percent (half of the federal statutory rate after allowing for the section 250 deduction) on GILTI and then allow a credit for 80 percent of foreign taxes paid on such income. However, state corporate income tax laws do not allow FTCs. As a result, all GILTI, from low- or high-tax countries, is subject to corporate income tax in states that conform to the provision. This

[48] There has been much discussion about how the TCJA has moved the United States from a global system of taxation to a territorial system. But generally a caveat is introduced here, as the description should be quasi-territorial, not territorial. The premise of the caveat and of the "quasi" description is that, no matter how one looks at it, neither GILTI nor IRC 965 repatriated income is properly to be regarded as "domestic."

[49] *See* Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17 (Dec. 18, 2017).

[50] *Id.*

disconnect between federal and state income tax rules significantly undercuts any notion that GILTI, at least at the state level, consists primarily of displaced domestic income, and instead ensures that the provision goes far beyond a focus on base erosion to include all or most foreign-source income for many taxpayers.[51]

The difficulty of determining how much, if any, of foreign-source income for U.S. taxpayers is displaced domestic income is evident in the conflicting justifications New Jersey provided in its 2018 bulletin that precluded taxpayers from apportioning GILTI using the receipts of the CFCs that generated the GILTI amounts. In the first version of its bulletin, New Jersey described GILTI and FDII as "a hybrid of different income items that are largely displaced U.S. income."[52] Three days later, the state reissued the bulletin, but this time significantly retreated from its displaced domestic income analysis by stating that "GILTI, by design, constitutes displaced U.S. income at least in part."[53]

Finally, and perhaps most compelling, the enormity of the foreign operations of U.S. multinationals belies any notion that foreign commerce is largely domestic commerce in disguise. In 2017, the companies in the S&P composite index (over 95 percent of which are U.S.-based) had aggregate sales of $10.54 trillion, of which 43.6 percent were foreign sales.[54] This is not surprising because 95 percent of the world's consumers live outside the United States. The notion that the income earned from these foreign sales should be taxed by the states (as GILTI or repatriated income) without appropriate factor representation, because the income is somehow substantially displaced domestic income, is contradicted by the realities of today's global economy. However fiscally lucrative it may appear, states cannot simply ignore that we live in a global economy where substantial markets and profits exist outside the United States.

It is worth emphasizing that the MTC in its proposed model combined reporting statute did not try to come up with a contrived factor representation for income from any "member that is doing business in a tax haven" — an income inclusion that was purportedly designed to counteract base erosion and profit shifting. Rather, it simply included in the water's-edge combined return the income and apportionment factors of such foreign member of the unitary group.[55] Under this method, if the foreign income is attributable to much higher, even extraordinary, profit margins, that is reflected in proportionately much lower foreign receipts to be included in the denominator of the sales factor.[56]

Identifying the most appropriate method for sourcing income from global trade is notoriously difficult. By way of illustration, the OECD BEPS project took three years of sophisticated analysis, and the proposed solutions that it arrived at are still being vigorously debated. Moreover, multinational taxpayers can legitimately assert that a tug of war is being conducted at their expense, with both the United States and the OECD countries claiming that they are entitled to bigger pieces of the same pool of income. Against this backdrop, subnational policymakers — the United States is one of the only large industrialized nations with a robust state and local corporate income tax system — should proceed with caution,[57] not based on broad and

[51] For a more detailed analysis, *see* Donovan, *supra* note 1. Some have criticized GILTI as going too far at the federal level because of the complex expense allocation rules that can unduly reduce a taxpayer's ability to offset GILTI with FTCs. *See* Allyson Versprille, Sony Kassam, and Siri Bulusu, "Treasury Pressed to Fix Tax Mistake That May Push R&D Offshore," *Bloomberg Tax*, Mar. 20, 2019.

[52] New Jersey Division of Taxation, "Tax Conformity to IRC Sec. 951A (GILTI) and IRC Sec. 250 (FDII)," TB-85 (Dec. 21, 2018).

[53] New Jersey Division of Taxation, *supra* note 15.

[54] Howard Silverblatt, "S&P 500 2017: Global Sales Year in Review," *S&P Dow Jones Indices*, at 5 (Aug. 2018).

[55] MTC, *supra* note 13, section 5A vii.

[56] As a policy matter, we do not believe states should be conforming with GILTI, but if they do, they should at least provide for appropriate factor representation.

[57] The OECD BEPS project found that profit shifting resulted in global corporate income tax revenue losses estimated between 4 percent and 10 percent of global corporate income tax revenues. However, the OECD final report cautioned: "This chapter concludes that the significant limitations of existing data sources mean that, at present, attempts to construct indicators or undertake an economic analysis of the scale and impact of BEPS are severely constrained and, as such, should be heavily qualified. One of the key challenges with currently available data sources is that it is difficult for researchers to disentangle real economic effects from the effects of BEPS-related behaviours." OECD, "Measuring and Monitoring BEPS, Action 11 — Final Report," at 15, 17 (2015).

unsubstantiated generalizations about what constitutes displaced domestic income.[58]

Theory: Only Taxpayer Factors Should Go Into the Denominator

Proponents of including GILTI or section 965 income in the tax base, without appropriate factor representation, may argue that it is conventional to include in the income tax base of a water's-edge group any of the items that fall into the federal income of one of the members, but to include factors only of the members of that group.[59] According to this argument, the GILTI earned by the foreign subsidiaries is the deemed income of the U.S. taxpayer or other members of the water's-edge group while the related receipts that generated the income are the receipts of the foreign subsidiary that cannot be a member of the group and thus should not be included in the group's sales factor denominator. New Jersey takes this position in its bulletin on GILTI factor representation, explaining that "taxpayers may not look through to the underlying sales [of the CFC] when determining how to allocate GILTI . . . because GILTI . . . [is] an item of receipt to the taxpayer, not its CFC subsidiary."[60]

We do not dispute this line of reasoning as a matter of mechanical statutory construction under pre-TCJA state corporate income tax statutes. But states with such a statutory scheme should nonetheless permit factor representation for the receipts and other factors of CFCs that give rise to GILTI and repatriated income for the following reasons:

- GILTI and section 965 repatriated income, like subpart F income, represent CFC income that is deemed to have been repatriated. Accordingly, the logic that led the MTC to propose including the factors regarding subpart F inclusions (and tax haven income inclusions) in the denominators of the apportionment formula under its model combined reporting statute applies equally to GILTI. In other words, if the MTC were drafting its model statute today, logic would compel it to treat GILTI and subpart F income identically.
- As discussed, when the income of the taxpayer's unitary foreign subsidiaries is included in the tax base in elective worldwide combination reporting, the factors of the foreign subsidiaries of course come along for the ride. This is true even though the foreign subsidiaries are technically not the taxpayer, but unitary members of the taxpayer's worldwide unitary group.
- The linchpin equation demands such treatment to avoid an unconstitutional result. It is useful to remind ourselves that the Supreme Court in *MeadWestvaco Corp.*[61] adjusted the law of business/nonbusiness income from a constitutional perspective, so that income paid by one business to another, as opposed to income on working capital, can only be included in the apportionment base of a non-domiciliary corporation if there are unitary ties between payor and payee. It is not enough that the taxpayer holds its interest in the payor for an operational purpose.[62] Why is this relevant to the question of factor representation? Because, under the linchpin principle, the Court in *MeadWestvaco* may have been signaling once again that including an item in the base of apportionable income is only appropriate when the denominators include the factors of the business whose income was swept into the base.[63]

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[58] *See* Sheppard, *supra* note 47. Sheppard implies that virtually all GILTI earned by CFCs is the result of base erosion and income stripping. According to Sheppard, "GILTI represents displaced domestic income. Congress did not believe that the offshored income it acted to claw back is really foreign or alien." *Id.* at 439, 442. *See also* Shanske and Gamage, *supra* note 38, at 970: "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." The Cobham and Jansky study cited by Shanske and Gamage does not support their position as it addresses U.S. profit shifting as a percent of global profit shifting, and not U.S. profit shifting as a percent of overall U.S. taxpayers' foreign-source income (e.g. CFC income).

[59] The members may be referred to loosely as "taxpayers," even though a unitary group often comprises both members that are subject to the state's tax jurisdiction (nexus members) and those that are not (non-nexus members).

[60] New Jersey Division of Taxation, *supra* note 15.

[61] *MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16 (2008).

[62] *Cf. Allied-Signal Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

[63] *See* Donovan, *supra* note 1, especially the discussion at 40-41 of *Mobil Oil* and *Container Corp.*

Theory: States That Piggyback on the Section 250 Deduction for GILTI Have Wide Apportionment Latitude[64]

Some argue that only the net amount of GILTI should be included in the sales factor denominator as another rough justice approach, justified this time by the fact that, in effect, only half of the income is being taxed by the states if the section 250 deduction is allowed. Against this, we would make the following points: First, the section 250 deduction was crafted to constitute a de facto rate reduction to implement Congress's purpose of using GILTI as a global minimum tax that taxes only low-taxed income.[65] Second, even if one insists on seeing it as reducing the amount of income pulled into the base rather than a rate reduction, the alleged inconsistency can more appropriately be corrected by reasonably reducing the receipts included in the denominator of the sales factor. As discussed above, there is no need to address this issue by inventing some totally irrational apportionment formula as New Jersey has done, or to punitively overcompensate by limiting the receipts factor to the net GILTI or section 965 repatriated income amounts. Depending on the margins of the businesses in question, these two approaches will yield vastly different and discriminatory outcomes compared with the traditional method of allowing taxpayers to apportion income using the factors that contributed to the generation of the income. Finally, some states that tax GILTI do not adopt the section 250 deduction, and among those that do, the value of the deduction will decrease to 37.5 percent in 2026.

VI. Conclusion

To be clear, in terms of the constitutionality of the taxation of GILTI or section 965 repatriated income, we are not saying that no state can tax these sources of income at all under *Kraft*. However, we are asserting the following:

- States with separate reporting requirements cannot tax either GILTI or section 965 repatriated income because they, by definition, are not taxing similar income of non-nexus domestic subsidiaries.
- States with water's-edge combined reporting cannot subject either GILTI or section 965 income to their income taxes without providing appropriate factor representation — consistent with what they do for similar domestic income. Failure to provide appropriate factor representation directly related to the locations where such income was earned constitutes unconstitutional discrimination against foreign commerce. Moreover, unless the U.S. taxpayer has a unitary relationship with the foreign subsidiary whose income is being included in the tax base, a state other than the commercial domicile cannot tax such foreign-source income.

We believe that if the states continue to preclude foreign factor representation for GILTI or section 965 income or unreasonably allow only net taxable foreign income to be included in the denominator of the sales factor, then a flood of litigation will occur in numerous states over the next five years. Moreover, when these factor representation cases ultimately reach the higher courts, they will be litigated as discrimination claims, and not undue burden or factor distortion claims. This will put the burden of proof on the states and tilt the eventual outcome to taxpayers. But there is no real need to await a decade of litigation and uncertainty over state budgets and taxpayer refunds that will be affected by the expected onslaught of litigation over the state taxation of new categories of foreign-source income created by the TCJA. The solution is clear for both categories. Section 965 repatriation is a one-time deal, but there is still time to provide guidance for recently filed returns and avoid litigation by providing adequate factor

[64] The most extreme embrace of such latitude is represented by the New Jersey approach, which bears no relationship whatsoever to the locations — inside and outside New Jersey — where the recipient corporation and its CFCs undertook the activities giving rise to the income. This approach, we believe, not only discriminates against foreign-source income in violation of *Kraft* on many common sets of facts, but it also fails the fair apportionment prong of *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

[65] *See* Donovan, *supra* note 1.

representation reflecting a variation of the Detroit Formula that some states have used regarding the taxation of foreign dividends. The taxation of GILTI is a present and future issue. The states should move from their current head-in-the-sand approach and provide reasonable factor representation like the model they use for virtually all other trade or business operating income: Allow the taxpayers to include the foreign factors that contributed to the generation of the income in the denominator of the apportionment factors. ■