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SHOP TALK

State Tax Impact of the Transition Tax and GILTI

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States have now had months to think about the Tax Cuts and Jobs Act's impact on their tax revenues, and to consider how best to legislatively respond. As of this writing, responses are slowly starting to trickle in. A key area to watch is how the states choose to conform to, or decouple from, the IRC Section 965 Deemed Repatriation (or Repatriation Transition) Tax and Global Intangible Low Tax Income ("GILTI") provisions. This article focuses on state tax issues relating to both. It is largely conceptual, but builds in examples of enacted state legislation. Overall, this article generally concludes that taxpayers should consider not only state conformity legislation, but also pre-existing authorities addressing state treatment of Subpart F income, dividend received deduction provisions, expense disallowance provisions, and receipts factor guidance.

This is a lot to consider and taxpayers should look for opportunities and ways of resisting potential challenges that result from the interplay between the federal tax code, state tax provisions, and their own unique facts.

IRC Section 965 deemed repatriation of deferred foreign earnings overview

IRC Section 965(a) requires shareholders to include in Subpart F income the accumulated post-1986 deferred earnings and profits of deferred foreign income corporations, as of November 2, 2017, or December 31, 2017, whichever period has a higher amount (the "965 Inclusion").

To soften the blow, a deduction is allowed to reduce the tax rate for the 965 Inclusion to 15.5% for cash or cash equivalents and 8% attributable to illiquid assets (the "965 Deduction").[1]

The resulting liability (the 965 Inclusion reduced by the 965 Deduction to rates of 15.5% and 8%) can be paid immediately or an election can be made to pay the amount over eight years.

Potential state tax results of 965 Inclusion conformity

It might be thought that the 965 Inclusion will be taxable in a state that conforms to the Tax Cuts and Jobs Act's provisions. However, it is not that simple. The analysis needs to go a step or two further. Specifically, one must consider how the conforming state treats Subpart F income and dividends from foreign subsidiaries. Some states exempt Subpart F income from tax or allow a full dividend received deduction. Accordingly, in some states conformity to the 965 Inclusion could produce no taxable income for state tax purposes due to these already-existing statutory carve-outs.

So conformity could mean that the 965 Inclusion is fully taxable or fully exempt under a state's law. But that is not all. A partial inclusion is also possible. For example, in a state that only allows a partial dividend received deduction (e.g., 80% or 90%) for foreign dividends, some percentage of the 965 Inclusion (e.g., 20% or 10%) would be taxable and not the full amount.

To add a further complication, a few states disallow deductions attributable to untaxed federal income (often some percentage of the untaxed federal taxable income). In these states, if the 965 Inclusion is not taxed because it is exempt Subpart F income or is eligible for a dividend received deduction, some amount of the 965 Inclusion may effectively be taxed because some expenses will be deemed attributable to the untaxed amount and then be taxed.[2]

Accordingly, state conformity to the 965 Inclusion could mean, depending on state law, that the 965 Inclusion: (1) is fully included in state income, (2) is excluded from state income, or (3) is partially included in state income.

Potential state tax results of 965 Deduction conformity

As explained above, the 965 Inclusion may be exempt or deductible, in full or in part, depending on state law. Therefore, taxpayers could come out ahead (i.e., reduce their overall income) in a state in which both the 965 Inclusion is exempt and the 965 Deduction is deductible.

This could be the end result in many states, absent some legislative fix, since most states allow for all deductions provided for in the Internal Revenue Code, unless there is a specific modification. A few states may have modifications that are on point and that clearly disallow the 965 Deduction, but in many states there will be nothing directly on point.

It is understandable that states will want to prevent taxpayers from receiving a double benefit (an exempt 965 Inclusion coupled with the benefit of the 965 Deduction). Hopefully this will be done legislatively. States that do not redress the double benefit legislatively should issue administrative guidance giving fair warning if they otherwise intend to deny the 965 Deduction.

Initial state legislative responses to the 965 Inclusion and Deduction

Conformity to the 965 Inclusion and 965 Deduction could lead to considerable state-level complications. Headaches, questions, and interpretive skirmishes could be avoided by decoupling from all of IRC Section 965. Instead, it is more likely that states will seek to decouple from the 965 Deduction while seeking to tax at least part of the 965 Inclusion.

Idaho is a case in point. It has enacted legislation that provides an addback for the 965 Deduction.[3] But there is no parallel provision to eliminate the 965 Inclusion. After application of a longstanding Idaho election that permits exclusion of 85% of controlled foreign corporation (CFC) dividends,[4] it appears that the net result in Idaho will be that 15% of the 965 Inclusion will be included in the Idaho tax base.

Georgia legislation indicates that the state's approach will be to deny the 965 Deduction where the 965 Inclusion has not been taxed.[5]

Keeping it simple, West Virginia has simply adopted all amendments made to the IRC after December 31, 2016, but before January 1, 2018.[6] This means that West Virginia is incorporating the 965 Inclusion and the 965 Deduction (although the 965 Inclusion may be eliminated, as Subpart F income is generally excluded from West Virginia income[7]).

As three state legislative responses indicate, a range of approaches are possible. Taxpayers should review carefully the legislation in high-impact states, including considering the potential application of the dividend received deduction, expense disallowance, and Subpart F authorities.

Pleading GILTI

The same framework used for considering the impact of Section 965 at the state level should be used to assess GILTI's state impact. Like the Section 965 regime, GILTI provides for a reduced rate on foreign income by way of an inclusion coupled with a deduction that reduces the rate. Again, the inclusion and the deduction must be considered separately.

The inclusion, which is provided for in IRC Section 951A, is not derived from earnings and profits, and accordingly may not clearly qualify as a dividend. Presumably, the inclusion is included in the state tax base.

The GILTI deduction is presumably available at the state level, but be careful. Some states conform to Line 28 of Form 1120 (i.e., taxable income before NOLs and special deductions), rather than Line 30 of Form 1120. In these states, the GILTI deduction is potentially unavailable because it is a special deduction[8] and Line 28 of Form 1120 is a taxpayer's taxable income before special deductions.

Again, a range of state responses is possible. At the principled end of the spectrum, Georgia allows the GILTI deduction to the same extent that there is a GILTI inclusion.[9] However, it would not be surprising if at least some states seek to tax the GILTI inclusion while disallowing the GILTI deduction, either legislatively or by arguing that the state generally does not permit special deductions.

Other issues: tax haven income and receipts factor impact

The above discussion may seem like a lot to mull over, and it is, but there are other related issues to consider as well.

Several mandatory unitary combined reporting states require tax haven income to be included in the combined group's tax base. In these states, at least arguably some of the foreign income currently subject to the 965 Inclusion and GILTI may already have been taxed. Taxpayers that have already paid tax on tax haven income in certain states should consider whether the state would be seeking to tax it a second time through the 965 Inclusion and the GILTI inclusion and the magnitude of this issue.

Consideration should also be given to the impact of Section 965 and GILTI on the receipts factor. In some states, intangible receipts such as dividends are excluded from the receipts factor. Other states source such receipts to the taxpayer's state of commercial domicile. Companies may want to check to gain comfort that any GILTI and 965 Inclusion income will not be included in their numerator in their state of commercial domicile and may want to see if they can include GILTI and 965 Inclusion income in the denominator of some states. One thing to think about as part of this analysis is whether the gross amount or net amount should be included in the receipts factor in a given state (to the extent it should be included at all).

Conclusion

The Tax Cuts and Jobs Act seems like ancient history, in that it was signed into law several months ago. However, the states are only now starting to enact responsive legislation. Companies will obviously want to think carefully about state conformity legislation, but also a host of other things, including state dividend received deduction provisions, expense disallowance provisions, receipts factor guidance, and tax haven provisions. There may be challenges or opportunities, or both, depending on a company's specific facts and the law in the states in which it has nexus.

[1] IRC Section 965(c)(1).

[2] The Connecticut Governor's bill signals that this is the approach Connecticut intends to take (i.e., to tax 10% of the Deemed Inclusion through its expense disallowance for exempt interest provisions).

[3] *See* Idaho House Bill No. 463 (amending Idaho Code § 63-3022 to add back "the amount deducted under the provisions of sections . . . 965 of the Internal Revenue Code . . . .")

[4] Idaho Code Ann. § 63-3027C.

[5] Amended Ga. Code Ann. § 48-7-21(b)(8)(A) ("The deduction, exclusion, or subtraction provided by . . . Section 965 . . . shall not apply to the extent income has been subtracted pursuant to this subparagraph.")

[6] *See* amended W. Va. Code § 11-24-3(a).

[7] *See* W. Va. Code § 11-24-6(c)(7).

[8] The GILTI deduction is provided for under IRC Section 250, within the section of the IRC entitled "special deductions for corporations."

[9] "The deduction provided by Section 250 shall apply to the extent the same income was included in Georgia taxable net income." Ga. Code Ann. § 48-7-21(b)(8)(A).