THE STATE CORPORATE TAX BASE AFTER TCJA

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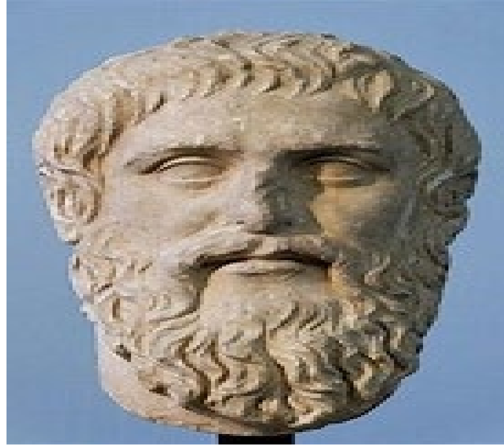

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Overview

The **Tax Cuts and Jobs Act** became law on December 22, 2017.

Background:

- Cuts federal corporate tax rate from 35% to 21%. “Target” was 20%.
- Senate reconciliation rules allowed tax legislation to pass with simple majority vote if it would “only” increase deficit by $2.1 trillion over 10 years.
- The legislation was designed to meet rate target while not exceeding debt limits. Those goals required use of some revenue-raising features that had been previously considered but not vetted. Many revenue increases back-loaded to 2025 and later tax years.
- Joint Committee on Taxation (JCT) used “dynamic forecasting” in estimating revenue effects of many provisions intended to encourage domestic economic growth.

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Key International Features of TCJA

- **Ends "deferral" of recognition of profits held U.S. owners of controlled foreign corporations (CFCs); the Mandatory Repatriation Tax imposed a one-time repatriation of retained CFC earnings going back to 1986 (at a significantly reduced rate), effective for the 2017 tax year.**
- **Foreign source dividends (ordinary earnings of CFCs) no longer subject to tax;**
- **Subpart F income (income of CFCs from intangible property passive/investment activity in low tax countries) continues to be taxed.**

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KEY FEATURES OF THE TCJA: GILTI

- If foreign dividends are no longer taxed, won't this encourage more income-shifting to low taxed countries? [Yes.]
- Solution: new tax on Global Intangible Low Taxed Income (GILTI). Tax calculations are complex, but:
    - Start with overall foreign earnings; assume 10% rate of return on foreign depreciable assets; everything above that amount (extraordinary profits) is subject to GILTI tax;
    - reduced 50% by IRC 250 deduction; reduced further by foreign taxes paid.
    - Essentially a 13% federal tax on extraordinary profits of CFC's not taxed by foreign governments.
    - Global Intangible Low-Taxed Income Definition | TaxEDU (taxfoundation.org)

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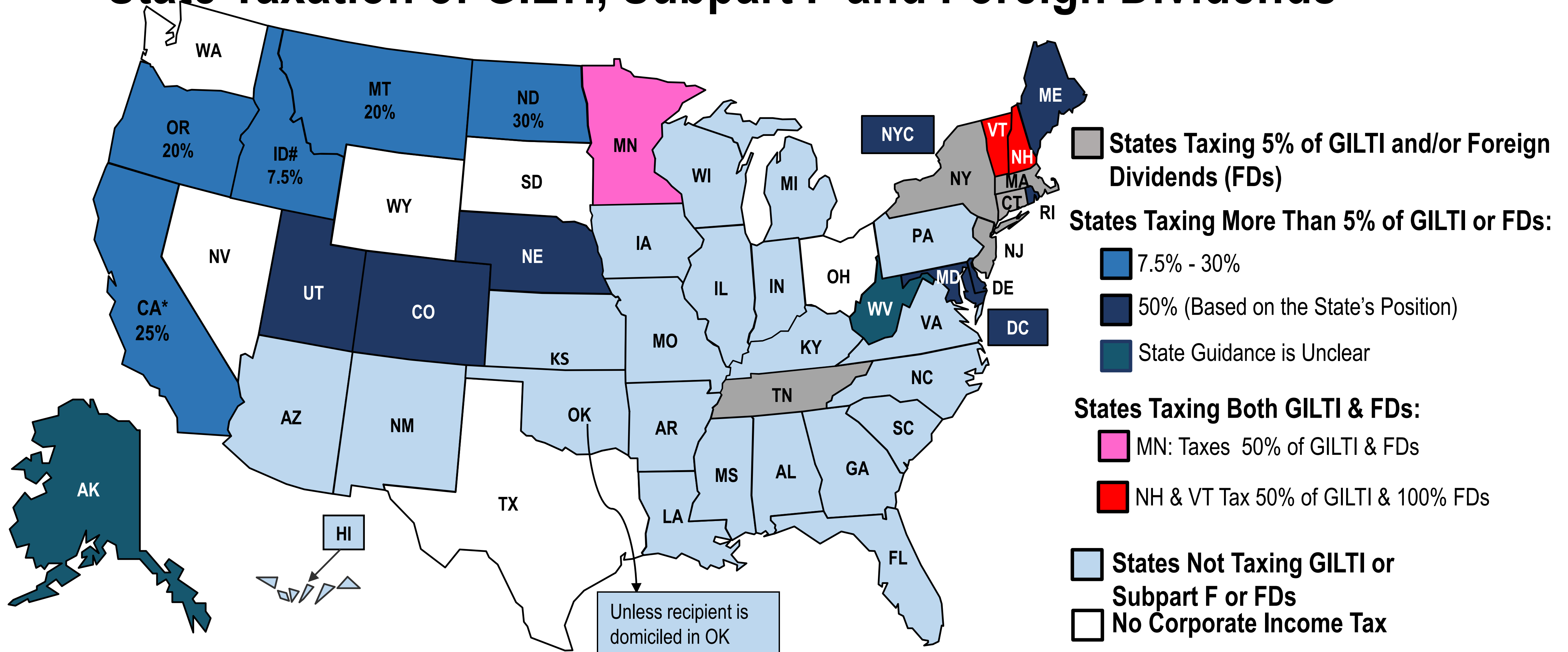
State Taxation of GILTI, Subpart F and Foreign Dividends



** CA taxes 25% of foreign dividends*

***Disclaimer**: This map is based on the best available information, but several states do not have clear guidance on GILTI. Therefore, this information should be used for general guidance and not relied upon for compliance*

Source: Council On State Taxation (August 2023)

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Key Features of the TCJA: FDII

Foreign-Derived Intangible Income (FDII) operates as the "carrot" to GILTI's "stick" to encourage domestic activity.

- "Extraordinary" profits on foreign sales of goods and services are allowed a 37% deduction; reduces federal tax rate to 13.1% for profits from overseas sales.
- Extraordinary profits defined as everything above an expected 10% rate of return on domestic depreciable assets.
- Does FDII really work in encouraging *new* domestic activity?

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The Cost of State Partial Conformity to the TCJA (2020 data)

Total federal corporate receipts: $2.67 trillion

GILTI: $225 billion ($440 billion before IRC 250 deduction)—most states decoupled or only tax ~5%, following foreign dividend tax treatment.

Subpart F income: $43.6 billion—most states had already decoupled after *Kraft* decision; some states tax 5%-25%.

FDII: $71 billion--most states did not decouple;

That is, TCJA policies represents 13% of the federal tax base, and a far higher percentage for Fortune 100: tech companies; pharmaceutical companies, etc.

Repatriation Transition Tax: states treated it as Subpart F income, i.e., mostly not taxed or taxed 5%. Now water under the bridge.

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ELIMINATING "FOREIGN SOURCE" INCOME HAS AN OUTSIZED EFFECT ON STATE TAX RECEIPTS

Isolating expenses associated with GILTI and Subpart F is almost impossible since these amounts represent profits from intangible property values that arise from business as a whole.

Thus, gross subtractions from the base have an outsized effect on net income, since there is no offsetting reduction of expenses.

Example: a multinational corporation with $50 billion in book net income, having $20 billion in GILTI, $20 billion in FDII and $10 billion in Subpart F income would have zero apportionable income in most states.

More to consider: GILTI and Subpart F amounts can be reported by "nexus isolated" domestic holding companies, eliminating tax liabilities on that income in separate entity states; same with water's edge combined fling states with an 80/20 company carve-out.

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What Drove State Responses to the TCJA?

1. **No time for study: the TCJA went into effect almost overnight, and included novel and poorly understood provisions;**

2. ***Kraft General Foods v. Iowa*, 505 U.S. 71 (1992): discrimination holding applied only to separate-entity state treatment of foreign dividends, but drove states to eliminate most foreign dividends (and Subpart F income!) from their tax bases.**

3. **Questionable JCT fiscal estimates: FDII estimate: $0.9 billion; Actual: -$71 billion. GILTI: estimate: $9.6 billion; Actual: $225 billion. (2020 tax year).**

4. **Desire to encourage economic development; TCJA may not have achieved its stated purpose of encouraging more domestic production. See Wharton Report in Appendix. Also, with single sale factor and market-based sourcing, state corporate tax impositions should not affect relocation decisions**

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Resources

- Wharton School, University of Pennsylvania, Budget Model, *Did Tax Cuts and Jobs Act of 2017 Increase Revenue on US Corporations' Foreign Income?* p.7 (1012/23), available here: https://budgetmodel.wharton.upenn.edu/issues/2023/10/12/did-tcja-increase-revenue-on-us-corporationforeign-Income.
- *Precision Cast Parts. Inc. v. Nebraska Dept. of Revenue,* Nebraska S.Ct. Docket No. A-23-564 (great briefing on the nature of Subpart F and Repatriation Transition Tax).
- Global Intangible Low-Taxed Income Definition | TaxEDU (taxfoundation.org) (good description of how GILTI is calculated; it's complicated.)
- Fleming, Tax in History, Available at: Acknowledging (Celebrating? Regretting?) Sixty Years of Subpart F by J. Clifton Fleming :: SSRN
- Publication 16 (Rev. 8-2023) (irs.gov) (statistics on corporate income tax revenues for 2020).
- According to the *Bloomberg Tax* reporting service, states taxing all or a portion of Subpart F income are: Alaska, California (25%), Colorado (varies), Idaho (50%), Kansas (20%), Maine (50%), Massachusetts (5%); Minnesota (50%); Montana (20%); New Hampshire; New Jersey (5%); New York (5%); North Dakota (50%); Oklahoma (allocated to commercial domicile); Oregon (20%); Utah (50%), and Vermont.
- B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders, Para.* 5.05 (5th ed. 1987).
- Fort, *State Taxation of MNE's under the TCJA: Time for a Policy Reassessment*, Tax Notes State, Vol. 112, No. 12, available at: www.mtc.gov

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