GLOBAL INTANGIBLE LOW-TAXED INCOME

- "Global Intangible Low-Taxed Income" is a term and concept created by the federal government during a recent restructuring of federal tax laws under the Trump Administration.
- There have been proposals in California to use the concept as part of the state's tax code, but such proposals raise constitutional issues and concerns about taxing income that is not related to activity within this state.
- The purpose of specifically defining Global Intangible Low-Taxed Income in the federal tax code was to prevent erosion of the tax base due to changes in the corporate tax structure under the Tax Cuts and Jobs Act (TCJA) passed by the U.S. Congress in 2017.
    - One of the tax reforms in TCJA provided a general exemption at the federal level for most foreign earnings paid to U.S. parent corporations through dividends.
- Under TCJA, Global Intangible Low-Taxed Income is subject to tax at a rate between 10.5 percent and 13.125 percent annually. This provision increases the tax liability for U.S. taxpayers that shift profits to foreign jurisdictions with lower tax burdens, thus reducing the incentive for moving operations out of the United States.
    - This is a new requirement imposed on U.S. shareholders to ensure that they pay a minimum amount of taxes on the earnings of controlled foreign corporations.
    - A business may exclude income from a controlled foreign corporation for calculating Global Intangible Low-Taxed Income if the foreign jurisdiction imposes a tax of at least 18.9 percent on that income (90 percent of the U.S. corporate tax rate), since the purpose of this additional tax is to prevent shifting of income to lower-tax countries.

WHAT IS THE WATER'S-EDGE ELECTION?

During the 1970s and 1980s, California's method of taxing business income created tension in the international community. In their view, California was infringing upon international trade agreements by taxing foreign income beyond the borders of the United States. At that time, California taxed income on a worldwide "unitary" basis, which meant that the income earned by foreign affiliates was subject to California's reporting and apportionment formula.

This "worldwide combined reporting" system of taxation led to numerous disputes with foreign governments and multinational businesses, who argued that it led to multiple taxation and violated the United States Foreign Commerce Clause. This eventually led to legislation, SB 85 (Alquist) of 1986, which provided an election for taxpayers to choose between reporting on a worldwide combined reporting basis, or water's edge.

Under the water's-edge election, the unitary or combined group is comprised only of those affiliated corporations within the "water's edge" of the United States (the 50 states and the District of Columbia). As a result, taxpayers doing business in California were allowed to elect to exclude income and factors of non-U.S. affiliates when apportioning income to California. When a taxpayer chooses this election, it must agree to file on this basis for 84 months or 7 years.

CALIFORNIA TAX FOUNDATION

The California Tax Foundation is a nonprofit, nonpartisan think tank established by the California Taxpayers Association in 1980. The foundation is dedicated to promoting sound tax policy and government efficiency.

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QUESTIONS TO CONSIDER WHEN INCLUDING GLOBAL INTANGIBLE LOW-TAXED INCOME AT THE STATE LEVEL

1. WHAT IS THE IMPACT ON TERRITORIAL TAX SYSTEMS?

The purpose of adopting this provision at the federal level was to ensure fairness during the federal government's transition into a quasi-territorial tax system, and avoid erosion of the tax base because of this fundamental change.

- California, in contrast, already has implemented a territorial tax system under both the worldwide reporting method and the water's-edge election.

2. HOW WILL TAX ADMINISTRATORS ACCURATELY INCLUDE GILTI INCOME AT THE STATE LEVEL?

The inclusion of global intangible low-taxed income at the state level would pose significant administrative challenges, for both taxpayers and the taxing agencies.

- Determining whether a foreign subsidiary would be included in the calculation would take a significant amount of time and effort. This analysis would be both fact-and data-intensive, and would require tax agencies to spend substantial amounts of time auditing to ensure compliance. This would require the hiring of new, highly trained auditors or the shifting of current auditors away from their existing workload, either of which would have an impact on the state budget that should be considered in any revenue projections associated with adopting this provision at the state level.

3. WHAT CONSTITUTIONAL ISSUES DO STATES NEED TO CONSIDER BEFORE TAXING GILTI?

- The lack of factor representation could lead to constitutional challenges on the basis that income is not being fairly apportioned to the business activity within the state.
- There is a potential for multiple taxation, as the proposal specifically excludes the high-tax exclusion provided at the federal level that allows companies to exclude income already taxed by a foreign jurisdiction.

4. HAS PRIOR LEGISLATION ENACTED IN CALIFORNIA ALREADY CONSIDERED TAXING THEIR INCOME?

- Before the water's-edge election was signed into law, a similar provision to the global intangible low-taxed income was included in the language of the reform legislation (SB 85 of 1986).
  - The provision would have included in the water's-edge group any affiliated banks or corporations located in a country where the statutory income tax rate was less than 65 percent of the maximum U.S. corporate income tax rate.
- The Legislature decided not to include this provision in the final bill, and instead chose to include the subpart F language that can be found in current law.

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EXAMPLE OF A SIMPLE CALCULATION

Matthew's Jean Company owns 100 percent of Pam's Denim Company. Pam's Denim does not have any U.S. effectively connected income, Subpart F income, income that would be subpart F but was highly taxed, dividends from related persons, or foreign oil and gas extraction income. Pam's Denim has an after-tax profit of $100 and interest expense of $5. The after-tax basis of depreciable tangible property for Pam's Denim is $80.

TESTED INCOME	
Total gross income	$100
Less: U.S. effectively connected income	$0
Less: Subpart F income	$0
Less: Income that would be subpart F income but was highly taxed	$0
Less: Dividends from related persons	$0
Less: Foreign oil and gas extraction income	$0
Equals: Gross tested income	$100
Less: Deductions allocable to gross tested income	$0
Equals: Tested income	$100
NET CFC TESTED INCOME	
Aggregate pro rata share of tested income of each CFC, less	$100
Aggregate pro rata share of tested loss of each CFC	$0
Equals: Net CFC tested income	$100
NET "DEEMED TANGIBLE INCOME RETURN" (DTIR)	
10 percent of qualified business asset investment (QBAI)	$8
Less: Interest expense	- $5
Equals: Net DTIR	$3
Net CFC tested income	$100
Less: Net DTIR	- $3
Equals: Global Intangible Low-Tax Income	$97

Even "simple" calculations demonstrate how complicated and data-intensive these calculations can be. The calculation demonstrated here does not take into account whether the controlled foreign corporation is unitary with the California taxpayer, nor if it serves an operational function in the taxpayer's business, which would require a fact-based analysis of the taxpayer and its business operations.

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