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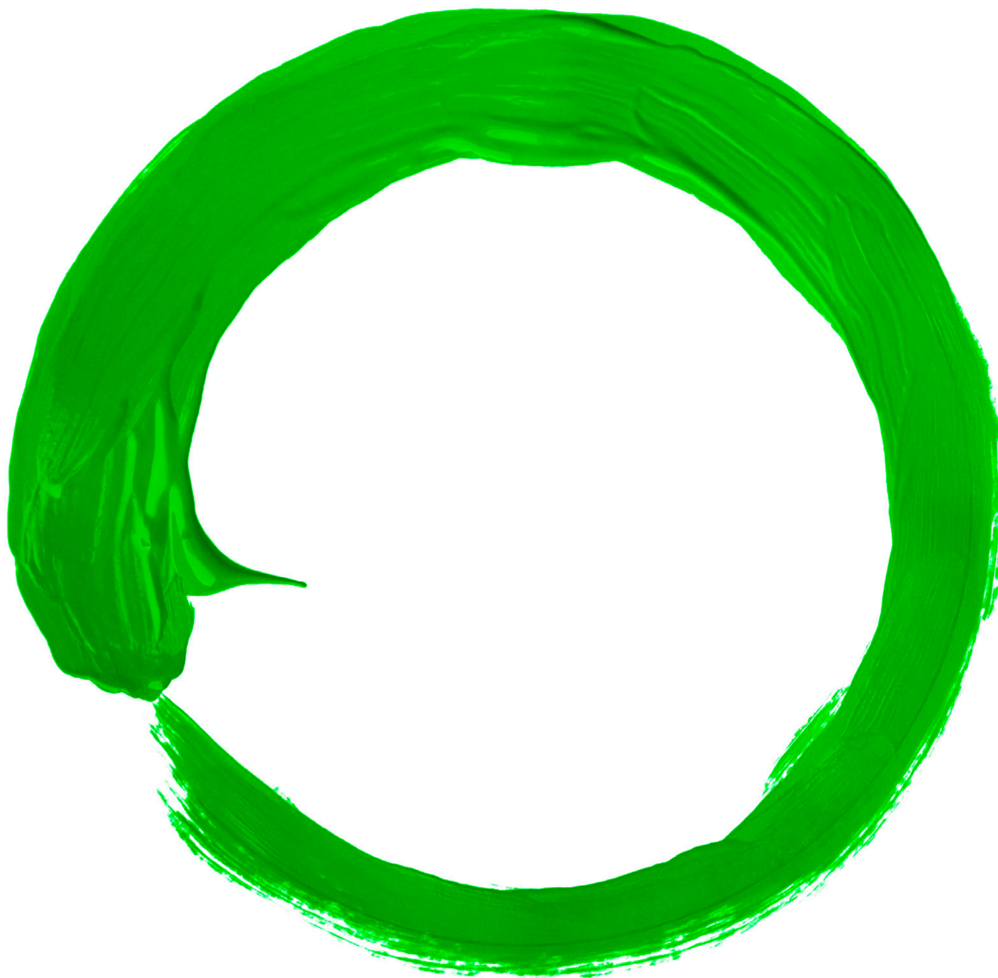

Inside Deloitte

GILTI high-tax exclusion: Impact on state taxes

By Alexis Morrison-Howe, Sarah Murray, Steven Spaletto, and Sara Clear, Deloitte Tax LLP

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by Alexis Morrison-Howe, Sarah Murray, Steven Spaletto, and Sara Clear

Alexis Morrison-Howe

Sarah Murray

Steven Spaletto

Sara Clear

Alexis Morrison-Howe and Sarah Murray are principals, Steven Spaletto is a managing director, and Sara Clear is a tax manager with Deloitte Tax LLP.

In this installment of Inside Deloitte, the authors examine the impact of the global intangible low-taxed income retroactive high-tax exclusion election on state income tax and future cash repatriation.

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When the concept of global intangible low-taxed income was introduced as part of the Tax Cuts and Jobs Act[1] in 2017, it required a sprawling state income tax analysis: Would states tax GILTI? How would the income be apportioned? The past few years have brought some, if not all, of the answers to those questions. In July 2020 the U.S. Treasury Department and the Internal Revenue Service promulgated final regulations under section 951A(c)(2)(A),[2] providing taxpayers with a retroactive high-tax exclusion (HTE) election to exclude specific controlled foreign corporation gross income from being subject to the GILTI regime to the extent such gross income was subject to foreign tax at rate that is greater than 90 percent of the U.S. corporate tax rate (the GILTI HTE).[3] As we will discuss in this article, while the GILTI HTE election presents a less formidable challenge from a conformity perspective, it will have ramifications on state taxable income in the year of the election as well as on the treatment of future distributions from foreign subsidiaries.

[1] P.L. 115-97, 131 Stat. 2054, 2208 (Dec. 22, 2017).

[2] T.D. 9902, 2020-33 IRB 349.

[3] *Id.*

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State Taxation of GILTI Generally

While a full discussion of the federal GILTI regime is beyond the scope of this article, it is worth articulating its material provisions and how they have generally been treated for state income tax purposes.

Section 951A, which was enacted by TCJA, requires a U.S. shareholder of any CFC to include in gross income such shareholder's GILTI for the year. The U.S. shareholder's GILTI inclusion is calculated as the aggregate of the shareholder's pro rata share of "tested income" of each CFC over the aggregate of the U.S. shareholder's pro rata share of the "tested loss" of each CFC, allowing a subtraction for a 10 percent return on qualified business asset investments and a modification for some specified interest. This gross GILTI under section 951A may be offset by a 50 percent deduction under section 250, subject to some income limitations of the shareholder.

States have generally fallen into one of three categories in their treatment of GILTI:

1. states that tax gross or net GILTI income with no state-specific subtraction (for example, the District of Columbia, Kansas, and New Jersey);[4]
2. states that include gross or net GILTI income in state taxable income but allow a dividends received deduction (DRD) or other subtraction of less than 100 percent or require the disallowance of expenses related to the deducted income (Massachusetts, Montana, and New York, for example);[5] or
3. states that do not conform to section 951A or allow a 100 percent subtraction for GILTI income with no associated disallowance of expenses (for example, California, Illinois, Minnesota, and Texas).[6]

Overview of GILTI HTE Regulations

While a full discussion of the final regulations promulgating the GILTI HTE is also beyond the scope of this article, they generally apply to tax years of foreign corporations beginning on or after July 23, 2020, and to the tax years of the U.S. shareholders "in which or with which such tax years of foreign corporations end."[7] Applying the GILTI HTE election is an annual election.[8]

A taxpayer may choose to apply the GILTI HTE election retroactively to tax years of foreign corporations that begin after December 31, 2017, and before July 23, 2020, and to tax years of U.S. shareholders "in which or with which such taxable years of the foreign corporations end."[9] Retroactive application of the GILTI HTE requires application of the GILTI HTE regulations in a consistent manner in each tax year in which the taxpayer applies the GILTI HTE.[10] Also, the GILTI HTE regulations provide the administrative mechanism to make the election. Controlling domestic shareholders (as defined in Treas. reg. section 1.964-1(c)(5)) of CFCs may make a GILTI HTE election by filing a statement with either a timely filed original return or an amended tax return as long as (1) the amended return is filed within 24 months of the unextended due date of the original return, (2) each U.S. shareholder affected by the GILTI HTE election files an amended return reflecting the effect of the election for tax years in which the U.S. tax liability would be increased, and (3) each U.S. shareholder affected by the GILTI HTE election pays any tax due as a result of the election within six months of the 24-month period.[11]

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[4]The District includes gross GILTI in taxable income. D.C. Code sections 47-1803.01, 47-1803.02(a), 47-1801.04(28). Kansas, New Jersey, and New York City include net GILTI in taxable income. Kan. Stat. Ann. sections 79-32,110(a), 79-32,138(a), 79-32,109(a); N.J. Stat. Ann. sections 54:10A-5(c)(1), 54:10A-4(k); N.J. Admin. Code sections 18:7-5.1(a)(2)(b), 18:7-5.2(a); and N.Y.C. Admin. Code section 11-652.8(a).

[5]Massachusetts allows a 95 percent deduction for GILTI. Mass. Gen. Laws ch. 63, sections 30(3), (4), 38(a)(1). Montana allows an 80 percent DRD for water's-edge filers. Mont. Code Ann. section 15-31-325(3), (4). New York allows a 95 percent deduction for GILTI and has an expense disallowance. N.Y. Tax Law sections 208.6-a(b), 209.1.(a), 210.1.(a), 208.8, 208.9(i). Utah includes net GILTI in taxable income, does not provide a deduction or subtraction, and has an expense disallowance. Utah Code Ann. sections 59-7-104, -101(19), (29), 59-7-106(3)(b).

[6]California and Texas conform to a version of the code before the enactment of the TCJA. Cal. Rev. & Tax. Code sections 23051.5(a), 17024.5(a)(1)(P); and Tex. Tax Code Ann. section 171.0001(9). Illinois treats GILTI as a dividend and provides a DRD with no expense disallowance. 35 Ill. Comp. Stat. 5/201(a), 5/203(b)(1), (b)(2)(O)(e)(1), (h), 5/1501(a)(11), 5/102. Minnesota provides a full deduction for GILTI with no expense disallowance. Minn. Stat. sections 290.01, subd. 31; 290.0134, subd. 17.

[7]Treas. reg. section 1.951A-7(b).

[8]Treas. reg. section 1.951A-2(c)(7)(viii).

[9]Treas. reg. section 1.951A-7(b).

[10]*Id.*

[11]Treas. reg. section 1.951A-2(c)(7)(viii)(A).

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Essentially, the GILTI HTE regulations provide that in calculating GILTI, a CFC may exclude gross income from its calculation of tested income or loss if it was subject to tax in a foreign jurisdiction at a rate that is greater than 90 percent of the U.S. federal corporate income tax rate.[12] The GILTI HTE applies to income subject to a foreign effective tax rate of greater than 18.9 percent, which is 90 percent of the 21 percent U.S. federal corporate income tax rate.

State Conformity to GILTI HTE Regulations

Of the three categories of states outlined above, the HTE election, if recognized by the state, would have a current-year tax impact in only the first two: states that do not either decouple from section 951A entirely or provide a 100 percent subtraction with no expense disallowance.

States that adopt the Internal Revenue Code for purposes of determining taxable income generally do so as of a fixed date in time (fixed-date conformity states) or adopt the current version of the IRC (rolling conformity states). The GILTI HTE is provided for in the Treasury regulations promulgated under section 951A, but not in the statute itself. Therefore, the question is whether the state conforms to the applicable regulation, even if it conforms to the underlying statute. Among the static conformity states, three provide a specific conformity date to the Treasury regulations: Indiana, Kentucky, and Texas.[13] Because Texas conforms to the IRC as in effect in 2007, it does not conform to section 951A at all.[14] Indiana and Kentucky, however, conform to a version of the IRC that includes section 951A, but they do not conform to a version of the Treasury regulations that would incorporate the GILTI HTE.[15]

The impact of nonconformity in those states may be limited as both states fall within the second category outlined above. Kentucky allows a full deduction for GILTI from its state taxable income.[16] It disallows a portion of expenses related to the untaxed GILTI, which could be affected by the amount of GILTI, as discussed later in this article, but Kentucky does not provide an explicit formula for how the modification should be calculated. Indiana applies its graduated DRD to GILTI based on ownership, allowing a 100 percent deduction for a CFC owned at least 80 percent, an 85 percent deduction for CFCs owned at less than 80 percent but more than 50 percent, and a 50 percent deduction for any remaining GILTI.[17] Accordingly, if a shareholder owns less than 100 percent of a CFC and files in Indiana, the GILTI HTE may affect the amount of taxable GILTI for Indiana purposes.

New Hampshire law provides that it does not follow any Treasury regulations, but its starting point is tied to federal taxable income.[18] The state has not indicated in any administrative guidance that it does not intend to follow the impact of the HTE election on the federal taxable income starting point. In the remaining states with a fixed-date conformity, where there is no specific guidance on conformity to Treasury regulations, the likely answer is that if the state conforms to a version of the statute that contains the operative provision the regulation was promulgated to interpret, that regulatory interpretation would apply. As of the date of this article, no state has enacted a modification to reverse the application of the HTE election or issued administrative guidance to indicate that it did not intend to follow.

Considerations for Reporting GILTI HTE On Prior-Year State Income Tax Returns

The GILTI HTE regulations are effective for tax years of foreign corporations beginning after July 23, 2020. However, the regulations allow taxpayers to retroactively elect the GILTI HTE for tax years of foreign corporations ending after

[12] Treas. reg. section 1.951A-2(c)(7)(i)(B).

[13] Ind. Code section 6-3-1-11; Ky. Rev. Stat. Ann. sections 141.010(15), 141.050(1); and Tex. Tax Code Ann. section 171.0001(9).

[14] Tex. Tax Code Ann. section 171.0001(9).

[15] Ky. Rev. Stat. Ann. section 141.010(15), 141.050(1); and Ind. Code section 6-3-1-11.

[16] Ky. Rev. Stat. Ann. section 141.039(1)(b); and KY-TAM-18-02, Ky. Dep't of Rev. (2018).

[17] Ind. Code section 6-3-2-12.

[18] New Hampshire does not explicitly adopt any of the Treasury regulations. N.H. Rev. Stat. 77-A:1(XX). However, computation of state taxable income begins with "federal taxable income before net operating loss deduction and special deductions." N.H. Rev. Stat. 77-A:1(III). The state did not conform to the post-TCJA version of the IRC until the tax year beginning on or after January 1, 2020.

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December 31, 2017, and before July 23, 2020, by filing an amended return.[19]

It is important to consider all three categories of states identified above when analyzing the state tax impact of an HTE election on prior-year returns. For states that taxed gross or net GILTI, the impact would be a clear reduction to taxable income to the extent federal GILTI is reduced. However, to the extent the GILTI was included in the sales factor denominator, there should be a corresponding adjustment that could increase the state apportionment factor. For the second category of states that provide less than 100 percent subtraction for GILTI income, there would be a similar derivative benefit from reducing federal GILTI, with a potential corresponding apportionment adjustment.

The benefit in the subset of states within the second category that allow a 100 percent subtraction but require expense disallowance may be overlooked. Expense disallowance rules that require that a portion of expenses related to the untaxed income be added back to taxable income are often imposed with little guidance on how to calculate the amount of the disallowance. While some taxpayers do a more detailed analysis of actual expenses incurred, many others use a percentage of the dividend deduction as a proxy; that is, if the DRD is $100 million, a taxpayer may take 5 percent of that deduction as the required addback and include $5 million in taxable income. To the extent that a taxpayer's expense disallowance in a prior year was based on a percentage of the DRD, it is important to recalculate that disallowance as part of the amended return and make the necessary modifications.

In the third category of states, which either decouple from section 951A entirely or allow a full subtraction without expense disallowance, the HTE election would not affect the amount of GILTI included in taxable income in the year of the election. However, there may be compliance considerations, which will be discussed later in this article.

Impact of Election on Future Cash Repatriation

While the relevant states in categories 1 and 2, apart from Indiana and Kentucky, are likely to follow the impact of the HTE election on federal taxable income, many taxpayers have not considered the potential state tax impact on future cash distributions.

To the extent an HTE election is made, the income is no longer considered previously taxed income under section 959. Thus, when a CFC makes a distribution to its U.S. shareholder, this repatriated cash may be eligible for the 100 percent DRD under section 245A and not be subject to federal income tax. However, that is not the case in the many states that decouple from section 245A and provide a statutory DRD of less than 100 percent or require expense disallowance. For states that apply the same subtractions to both GILTI and dividends, it may be a matter of timing — the income not taxed as GILTI is later taxed as a dividend, and the resulting amount of tax is the same. For example, California did not tax section 965 income in 2017; in the years following the TCJA, taxpayers who made distributions of that income may have been caught off guard when they learned that those distributions were taxable in California. It also represents another layer of state-only tracking that must be done when looking at foreign earnings and profits.

In states where GILTI is treated less favorably than cash dividends, there may be an additional benefit to making the election. For example, New Jersey provides that GILTI is not eligible for a DRD and therefore includes all of a taxpayer's net GILTI in entire net income. Cash dividends from wholly owned subsidiaries, on the other hand, are generally eligible for a 95 percent DRD. So, for example, if a taxpayer with a 5 percent New Jersey apportionment factor recognized $100 million of GILTI, there would be a significant difference between a scenario in which it did not make an HTE election and a scenario in which all of the GILTI was eligible for the election but was later repatriated in cash to the United States:

[19] Treas. reg. section 1.951A-7(b).

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	No HTE Election	HTE Election and Subsequent Cash Repatriation
Gross Income	$100,000,000	$100,000,000
Allowable Deduction (section 250 or DRD)	$50,000,000	$95,000,000
Taxable Income	$50,000,000	$5,000,000
Apportionment	7%	7%
Tax Rate	10.5%	10.5%
Tax	$367,500	$36,750

Additional Considerations for Reporting the GILTI HTE on Amended State Income Tax Returns

Taxpayers are required to file amended federal income tax returns in order to retroactively claim the GILTI HTE election for the 2018 and 2019 tax years. Besides the reduction in federal taxable income, other changes to the federal report from electing the GILTI HTE include, but are not limited to, changes to federal taxable income starting points (that is, federal Form 1120, lines 28, 29b, and 30), state income modifications such as federal income tax deductions where applicable, state tax liabilities, and the use or generation of state tax attributes.

The states generally do not have minimum thresholds under which the state impact of the federal changes is not required to be reported. Also, states generally specify a period for filing state amended returns to report the state impact of the federal adjustments (for example, 30, 60, 90, 120, 180, and 365 days after federal adjustments are finalized).[20] However, what constitutes the "final determination" of a federal adjustment is not defined in many states, and states that do define it use a variety of terms that are open to interpretation (for example, agreement, acceptance, execution). Furthermore, not all states' statutes or regulations on reporting federal adjustments specifically mention federal amended returns.

Given the lack of clarity and risk of refunds being denied if not timely filed, a conservative approach is advisable in computing state amended return due dates. In the context of federal amended returns, taxpayers often use their signature date on the federal amended return as the final determination date of the federal adjustments (commencing the period for filing state amended returns) or the expiration of states' statutes of limitations (if it is before the end of the applicable period for filing the state amended return to report federal adjustments).

Many nuances exist in this area, including differences that depend on whether the state amended return reflects tax due or a refund; has been filed on a combined versus separate company basis; and in at least one state, on which tax year is being amended. Another consideration is local amended returns, some of which can be due before the amended return is due for the state in which the taxpayer files returns (for example, the city of Portland business license tax/ Multnomah County business income tax and the Oregon corporate excise/income tax).

Given the potential variations in calculations required because of states' rules and filing methods, taxpayers should begin working on the state amended returns as soon as possible once federal amounts are ascertainable rather than waiting for the federal amended return to be signed and filed. Failure to timely file can result in denial of refunds or the assessment of additional penalties and interest.

Taxpayers electing to apply the GILTI HTE to tax year 2018 or 2019 must file an amended federal return within 24 months from the original due date of the return as outlined within the GILTI HTE regulations. Application of the GILTI HTE not only recalculates GILTI in accordance with the regulations, it may also result in a reduction in federal taxable income (or even an increase in a net operating loss) that taxpayers are required to report to states by timely filing amended returns using each state's required amended form in most states, even when adjusting the amount of NOL generated in a given year.

In summary, the election to retroactively apply the GILTI HTE and amend federal tax

[20]The following are the approximate number of states within each reporting period; 30 days: two states; 60 days: four states; 90 days: 15 states; 120 days: four states; 180 days: 13 states; and 365 days: two states. These reporting periods apply for tax year 2018 and forward.

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returns immediately starts the clock on the reporting of the federal adjustments to the states within each states' reporting period. While seemingly straightforward, the recalculation of GILTI for state purposes may create unforeseen challenges to overcome, all the while trying to meet the state's reporting periods.

Conclusion

Application and election of the GILTI HTE may have implications that far exceed simply recalculating the amount of GILTI includable in federal taxable income under IRC section 951A and filing a couple of amended returns. On the federal level, it also affects the amount of the deduction under section 250 and changes the classification of income that would have previously been GILTI and subsequently PTI. However, these implications are exacerbated on a state level not only by having to navigate each state's unique incorporation of the federal GILTI and GILTI HTE rules in order to report the changes appropriately, but also by having to promptly report any amended federal changes in each state in which the taxpayer files. ■

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