

State Tax Conformity to GILTI High Tax Exception Regulations

Overview

On July 20, 2020 the Treasury and the IRS released final high-tax exception GILTI regulations (“HTE Regulations”).¹ While a full discussion of the complexities of the HTE Regulations is beyond the scope of this Alert, these regulations provide an election to exclude certain items of income that were subject to an effective rate of foreign tax equal to at least 90% of the U.S. corporate tax rate, or 18.9%, from the computation of GILTI. The final regulations allow taxpayers to amend their previously filed returns to claim the HTE.

State Tax Conformity to Treasury Regulations

States generally adopt the Internal Revenue Code (“IRC”) on either a rolling basis or as of a fixed point in time. Section 951A of the IRC does not have any provision for an HTE to GILTI. Instead, the definitions and rules are outlined entirely in the HTE Regulations that were promulgated to interpret and carryout the statute, as enacted by the Tax Cuts and Jobs Act (“TCJA”).

States with a rolling conformity to the IRC should adopt any applicable changes to the Treasury Regulations as they are promulgated. While many states have a fixed date of adoption of the IRC, only three states, Texas, Kentucky, and Indiana, have a fixed date of conformity to the Treasury Regulations themselves². Because Texas conforms to the IRC as in effect in 2007, it does not conform to section 951A at all.³ Kentucky allows for a full deduction for all GILTI income, while Indiana only allows a full deduction for GILTI income where the US shareholder owns at least 80% of the applicable controlled foreign corporation (“CFC”).⁴ To the extent a shareholder owns less than 80% but more than 50% of a CFC, Indiana allows an 85% dividend received deduction (“DRD”) for GILTI income and a 50% DRD for all other GILTI income.⁵ Accordingly, as long as CFC is at least 80% owned, there would not generally be any anticipated state tax impact in those states with a fixed Treasury Regulation conformity date.

In the remaining states that have a fixed date of conformity to the IRC but no clear conformity to the Treasury Regulations, the HTE Regulations should be considered interpretations of section 951A as enacted by the TCJA. Thus, to the extent that the state has not decoupled from this section, tested income or loss for federal tax purposes after application of the HTE Regulations would generally be the applicable tested income or loss for state tax purposes.⁶

State Tax Impact of HTE Election

In states that tax GILTI, the HTE would act to reduce the amount of income included under section 951A. Many states conform to section 951A but then allow a subtraction for some or all the GILTI income. Some of these states require, however, that there be an addback of previously deducted expenses related to the subtracted income, generally referred to as “expense disallowance.” If the amount of GILTI income is reduced, the amount of related expense disallowance may be correspondingly reduced. Thus, if taxpayers file an amended return to claim HTE in prior years, there may be a state benefit, even in certain states that allow a GILTI DRD or subtraction.

¹ 85 Fed. Reg. 44620.

² Tex. Tax Code Ann. § 171.0001(9); Ky. Rev. Stat. Ann. § 141.010(15); Ky. Rev. Stat. Ann. § 141.050(1); Ind. Code § 6-3-1-11

³ Tex. Tax Code Ann. § 171.0001(9).

⁴ Ky. Rev. Stat. Ann. § 141.039(1)(b); KY-TAM-18-02, Ky. Dept. of Rev. (2018); and Ind. Code § 6-3-2-12.

⁵ Ind. Code § 6-3-2-12

⁶ 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 has not yet issued any guidance with respect to the HTE. The state did not conform to the post-TCJA version of the IRC until the tax year beginning on or after January 1, 2020.

External Multistate Tax Alert

If the HTE is made, the income would not be previously taxed income under section 959 when repatriated to the US. For federal tax purposes, this income may be subject to the 100% DRD available under section 245A. However, many states decouple from section 245A and apply a DRD of less than 100% and/or expense disallowance. Unlike differences in taxable dividends related to section 965 conformity, which only affect a small population of states, this difference would generally affect any state with a DRD of less than 100% and/or expense disallowance.

Because the impact of the election is highly fact sensitive, modeling is recommended to fully understand the impact of the HTE for state income tax purposes on amended or original returns.

Considerations of Application of Federal Election to States

The HTE is made by the controlling domestic shareholders of a CFC on an originally filed or amended federal tax return. Due to differences in federal and state income tax law, there may be different considerations as to whether the HTE is favorable. For example, a decision not to claim the HTE driven by foreign tax credits may not be the same decision that would be made in the state tax context where foreign tax credits are not available. However, unless a state provides an opportunity to make a separate election for state purposes, the election made on a taxpayer's federal tax return for each CFC may likely be binding for state income tax purposes.⁷

Contacts:

If you have questions regarding these regulations or the state income tax impacts of GILTI, please contact any of the following Deloitte professionals:

Alexis Morrison-Howe

Principal

Deloitte Tax LLP
Washington National Tax – MTS
+1 617 437 2345
alhowe@deloitte.com

Sarah Murray

Principal

Deloitte Tax LLP
Multistate Tax Services
+1 713 982 2547
sarmurray@deloitte.com

Valerie Dickerson

Partner

Deloitte Tax LLP
Washington National Tax - MTS
+1 202 220 2693
vdickerson@deloitte.com

Snowden Rives

Senior Manager

Deloitte Tax LLP
Washington National Tax - MTS
+1 202 220 2753
srives@deloitte.com

For further information, visit our website at www.deloitte.com

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⁷ We are not aware of any state as of the time of this Alert that taxes GILTI and would allow a different election.