Taxing the GILTI: Reversing a 2018 Policy, MA Can Fight Corporate Tax Dodge & Raise $450 Million a Year

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For an Executive Summary of this report, click here.

The reasons companies choose to open, to expand, and to remain in a given state are linked directly to the many investments made by state and local governments. A well-educated and healthy workforce; safe and reliable roads and bridges, and a public transit infrastructure that works for all; stable and affordable communities in which workers and their families can thrive - all of these provide the bedrock on which successful businesses and a vibrant state economy are built. As such, businesses have an important role to play in supporting state and local governments with their tax dollars.

Unfortunately, many large, profitable U.S. multinational corporations go to great lengths to reduce their taxable income, costing the federal government and states billions in lost revenue. In particular, many U.S. multinationals engage in complex accounting maneuvers that shift income generated in the U.S. onto the books of overseas subsidiary companies. These subsidiaries are set up in low- and no-tax jurisdictions (also known as “tax havens”), such as the Cayman Islands or Cyprus, for the express purpose of reducing the parent corporation’s taxes.

Corporate income shifting is widely understood to be a very large problem. Recognizing the scope and scale of the problem, federal lawmakers established, as part of the 2017 Tax Cuts and Jobs Act, a special process for identifying some of this shifted income and then taxing a portion of it. Known as the GILTI provision (for “Global Intangible Low-Taxed Income”), this provision allows the federal government and states to recoup some of the tax dollars lost to aggressive corporate income shifting.

In a costly decision, the Massachusetts Legislature voted in 2018, as part of a supplementary spending bill, to allow businesses to exclude 95 percent of GILTI from Massachusetts taxation. If left to stand, this choice will cost the Commonwealth as much as $450 million in lost revenue in the current tax year (2020). This is revenue that otherwise would come from profitable, multinational corporations doing business in Massachusetts - and in particular, from ones that are gaming the tax code. An affirmative decision by state lawmakers to recouple the Massachusetts tax code to the federal GILTI provision would allow the Commonwealth to collect these lost tax dollars, in 2020 and future years.
What Is GILTI and How Big Is the Problem?

Global Intangible Low-Taxed Income – or GILTI – is corporate income that has been generated through business activity occurring inside the U.S. (or other tax jurisdictions), but which corporations have shifted to foreign subsidiaries in low- or no-tax jurisdictions. Were these profits not shifted to overseas tax havens – typically done by using complex accounting schemes – the corporations would be required to pay both federal and state taxes on the U.S.-generated portion of this income.

There is broad consensus among tax authorities and other tax experts that these abusive tax avoidance practices are widespread and significantly undermine federal and state corporate tax collections. Preliminary estimates from a team of economists at the Wharton School of Business indicate that, under recent federal tax law changes meant to identify and combat profit shifting, $429 billion of profits of U.S. multinational corporations will be deemed GILTI in 2020. This income will be understood, for U.S. tax purposes, to have been shifted to avoid taxation either in the U.S. or other “higher-tax” countries (for example, France or Germany). The new federal tax law apportions 50 percent of total global GILTI to the U.S., as a rough approximation of the share of the global total shifted out of the U.S. Extending these estimates out ten years, the Wharton team’s analysis shows GILTI growing to $683 billion per year by 2030. (See Appendix A for a summary of the Wharton team’s preliminary estimates. As the Wharton team notes, it is likely that, over time, corporations will respond to the GILTI provision with new tax avoidance schemes, which may reduce these out-year totals significantly if additional measures are not taken.)

Using different methods, a separate, detailed examination of the relevant data concludes that corporate profit shifting cost the federal government over $100 billion in lost tax revenue in 2017 alone, or “more than a third of all federal corporate tax revenue” in that year. This total does not include the very substantial downstream effects that such profit shifting has on state tax collections.

How Much Revenue Is Massachusetts Losing by Not Adopting the Federal GILTI Provision?

As noted above, the Wharton economists have generated preliminary GILTI estimates for the entire United States of $429 billion in 2020, growing to $683 billion by 2030. The Wharton team further finds that approximately $12.5 billion of the current year (2020) total would be apportioned to Massachusetts for purposes of state taxation under current law. Applying the state’s basic corporate tax rate (8 percent) to this preliminary, state-level estimate ($12.5 billion of GILTI apportioned to Massachusetts), MassBudget calculates that the Commonwealth would be collecting some $500 million in GILTI-related corporate taxes in 2020 had the state remained coupled to the federal GILTI provision.

Currently, however, Massachusetts is taxing just 5 percent of GILTI apportioned to the state, as opposed to the 50 percent that the federal government has chosen to include in its corporate tax base. In 2018, in a set of outside sections tucked into a mid-year supplemental spending bill, Massachusetts lawmakers approved language decoupling the Commonwealth from the federal GILTI provision and reducing the amount of GILTI subject to state taxation by 90 percent. This technical change results in the Commonwealth forgoing up to $450 million a year in revenue by failing to adopt the federal approach to taxing GILTI. Were lawmakers to reverse this 2018 decision, the Commonwealth could collect this additional revenue in 2020 and future years.

Notably, additional GILTI tax revenue collected by the Commonwealth would not come from Massachusetts businesses that operate solely in-state or solely within the territorial U.S. The additional
GILTI revenue would come exclusively from profitable, multinational corporations that are choosing to shift income generated in Massachusetts to subsidiaries in foreign low- or no-tax jurisdictions.

When profitable multinational corporations shift income to subsidiaries in foreign low- or no-tax jurisdictions, they are not just reducing their own taxes, they are gaining an unfair advantage over their domestic competitors that cannot (and multinational competitors that do not) engage in offshore income shifting. Recovering this shifted income therefore not only helps fund the many state investments on which all businesses depend, it also helps restore a level playing field among corporate taxpayers of all types and sizes.

**How Are Other States Handling GILTI?**

According to the Tax Foundation, nine states – including Maine, Vermont, New Hampshire and Rhode Island – have adopted the federal GILTI provision and have issued guidance, taxing 50 percent of GILTI apportioned to their state. Five other states (and the District of Columbia) include the federal GILTI provision in their tax codes as a result of automatic conformity with the federal code, and thus currently are set to tax 50 percent of GILTI, though they have not yet issued final guidance on how the provision will be applied. (Utah, included in this group, is set to tax 100 percent of GILTI, but has not issued guidance yet.) The codes of another ten states include taxation of less than 50 percent of GILTI, though not all of these states have issued final guidance.15

**How Do Corporations Shift Income to Avoid Taxes?**

Corporations engage in a wide array of practices aimed at reducing their taxes. One common form of abusive tax planning by large, multinational corporations is the use of complex accounting maneuvers to shift income generated by their operations in a higher-tax jurisdiction to a subsidiary company intentionally located in a low- or no-tax jurisdiction.16 These maneuvers (also known as “income-stripping”) usually will place the shifted income beyond the reach of the higher-tax jurisdiction’s tax authorities.17 The GILTI provision is one of several provisions aimed at recapturing a portion of the revenue lost to such tax avoidance schemes.

In practice, the legal and accounting aspects of these maneuvers can be very complex - and even have their own names that suggest their complexity, like the “Double Irish Dutch Sandwich.”18 The following, however, is a simplified example of how income can be shifted: A U.S. multinational corporation can create a subsidiary in a foreign low- or no-tax jurisdiction (i.e., a “tax haven”, like the Cayman Islands, Cyprus or the Seychelles). The U.S. parent corporation then transfers legal title of some intangible asset - like a trademark or patent - to the subsidiary. The U.S. parent corporation then “pays” very high fees to its foreign subsidiary for the “right” to use its own trademark or patent. The result is that, for tax purposes, the multinational can claim that the U.S.-based parent company or affiliate, located in a relatively higher-tax jurisdiction (like the U.S.), has generated little or no income, while its foreign subsidiary (located in an overseas tax haven) has turned an enormous - and untaxed - profit.

It is by using accounting shell games like these that corporations transfer otherwise taxable income to jurisdictions beyond the standard reach of U.S. tax authorities.
How Can the Commonwealth Tax the GILTI?

Recognizing the scope and scale of corporate profit shifting – and recognizing that changes in corporate tax law included in the 2017 Tax Cuts and Jobs Act (TCJA) could make the problem worse – federal lawmakers included in the TCJA a number of new anti-abuse provisions. Foremost among these was the GILTI provision.

It is not feasible for federal and state tax authorities to identify, comprehensively, shifted income at a company-specific, dollar-by-dollar level, particularly in the absence of strong U.S and state-level corporate tax disclosure requirements. Given these constraints, the GILTI provision instead offers a practical workaround, providing a method for identifying income that very likely has been shifted from the U.S. to overseas low- and no-tax jurisdictions. Once identified, this income can be taxed at the state and federal levels.

While the mechanics of the GILTI calculations can be complicated, at the basic, conceptual level, the process is relatively straightforward. The GILTI provision requires that corporations total up the physical assets of all their foreign subsidiaries (i.e., factories, warehouses, equipment, etc.) and calculate what a 10 percent return on these assets would equal. If the combined profits of a corporation’s foreign subsidiaries exceed this 10 percent maximum “routine rate of return”, the excess profit is understood to be the result of income shifting, from higher tax jurisdictions (like the U.S.) to low- or no-tax jurisdictions. Under the federal provision, this income is deemed GILTI.

Once a corporation’s GILTI total has been determined, the federal provision then allows the corporation to reduce this calculated total by half, under the assumption that only half of the total excess profits was generated originally in the U.S. Many large, multinational corporations have operations all over the world and also are engaged in income shifting from other higher-tax locations (for example, France or Germany), in order to avoid taxes in those jurisdictions as well.

Finally, the half of the corporation’s calculated GILTI deemed to have originated in the U.S. is added to the corporation’s total taxable U.S. income and is subject both to U.S. federal tax and to state-level tax in those states that conform to the GILTI provision. For corporations that might feel unjustly taxed due to the GILTI formula, Massachusetts provides a helpful alternative: filing under the rules of World Wide Combined Reporting (see breakout box, above).

An Alternative to GILTI: World Wide Combined Reporting

For any corporation that feels its overseas profits have been incorrectly identified as GILTI, Massachusetts already offers a remedy: the option to file taxes under the rules of World Wide Combined Reporting (WWCR).

WWCR allows a corporation to provide the Department of Revenue with a full accounting of its combined, worldwide profits, along with a detailed breakout-by-country of its actual business operations (payroll, property and sales). The full 100 percent of the corporation’s profits then can be divided, for tax purposes, among the various tax jurisdictions around the world in which it operates, based on the share of the corporation’s total actual business activity that takes place in each location.

The purpose of the GILTI provision is to provide a rough framework for identifying and assigning shifted profits, for tax purposes, to the locations in which they actually have been generated. WWCR eliminates the need for this guess work; it treats all income of the corporation in the same way and uses the same reasonable formula to apportion this income among tax jurisdictions.
Are States within Their Legal Rights in Taxing GILTI? 

The states that have chosen to adopt the federal GILTI provision and tax this income are on very solid legal ground. Long-established legal precedents governing the taxation of corporate income leave little room for multinational corporations to argue successfully against the taxation of GILTI at the state level. The U.S. Supreme Court has upheld repeatedly the validity of apportioning corporate income by formula for purposes of taxation. These rulings stretch back to the nineteenth century and provide the basis for taxation of corporate income within the U.S. The Court likewise has upheld, twice, the use of formulas to apportion the worldwide income of corporations, most recently in 1994.

Implicit in these rulings is an understanding that states need not accept at face value a corporation’s assertions as to how much of its income has been generated in - and, hence, is taxable in - various jurisdictions. The law is clear: it is the taxing authority that gets to decide how taxable income is apportioned, not the tax filer. As long as states employ reasonable formulas as they attempt to apportion a corporation’s income, the Court repeatedly has found this approach to be constitutional.

The principal recourse then for a corporation that seeks to contest how its income has been apportioned is to demonstrate that the state’s formula is unreasonable. The burden of proof for such a claim falls on the taxpayer and the Court has set a high bar here, requiring the taxpayer to “prove by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted in that State.”

It is doubtful that a taxpayer will be able to meet this burden and show that taxation by the Commonwealth, having adopted the federal GILTI provision, is unreasonable. First, as explained above, the GILTI provision of federal law provides a formula for determining how much of a multinational corporation’s worldwide income should be apportioned to the U.S. for tax purposes. Choosing to conform to this federal formula is clearly a reasonable choice for a state. Once the total U.S. income of a corporation has been determined, in part through use of the GILTI provision, the states must then apportion this income among themselves. There can be numerous reasonable ways for a state to do this. The formulas Massachusetts uses for apportioning U.S. income (including the percentage of GILTI that Massachusetts elects to include in U.S. income) have been upheld by the Supreme Court on multiple occasions. And, as noted above, if a particular corporation believed that the Massachusetts approach treated its income unreasonably, it would have the alternative of opting instead for use of World Wide Combined Reporting, which the Supreme Court likewise has recognized repeatedly as a reasonable approach.

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3. Cobham & Jansky, "Measuring Misalignment: The Location of Multinationals’ Economic Activity vs. the Location of Their Profits", July 2017: https://onlinelibrary.wiley.com/doi/full/10.1111/dpr.12315 (From introduction: “The issue of corporate tax avoidance and tax havens is of first-order importance for the world economy. As we show in this article, as much as a quarter of the global profits of U.S. multinationals may be shifted to locations other than where the underlying real activity takes place.”)

Jane G. Gravelle, “Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?”, April 2016, http://www.law.nyu.edu/sites/default/files/upload_documents/Jane%20Gravelle.pdf (From pg. 1: “While the magnitude of corporate profit shifting by U.S. multinationals into low or no tax countries is uncertain, there is overwhelming evidence of its existence and its increase in recent years.”).
Clausing et. al, “Profit Shifting Before and After the Tax Cuts and Jobs Act”, January 2020 (From conclusion, pg. 32: “U.S. multinationals, aided by a permissive regulatory environment, became renowned profit shifters...By 2017, profit shifting by U.S. multinationals reduced corporate tax revenues by large magnitudes, regardless of the data set or method employed (to analyze the problem)...”): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3274827

Recognizing the scale of the problem, the Organization for Economic Cooperation and Development (OECD) has created a framework specifically focused on the issue of corporate base erosion and profit shifting (BEPS). From the OECD homepage for this project: “BEPS practices cost countries 100-240 billion USD in lost revenue annually, which is equivalent to 4-10% of the global corporate income tax revenue.”


TaxAnalyst, State Tax Notes, Shankse & Gamage, “Why States Should Tax the GILTI”, March 4, 2019 (see pg. 751): https://www.repository.law.indiana.edu/facpub/2746/

These very substantial tax law changes were tucked into the outside sections of a mid-year, supplemental spending bill. See Chapter 273 of the Acts of 2018, Sections 7 thru 16: https://malegislature.gov/Laws/SessionLaws/Acts/2018/Chapter273

A MassBudget calculation based on Massachusetts-specific GILTI estimates generated by researchers at the University of Pennsylvania using the Penn-Wharton Budget Model. For calculation details, see Endnote #13, below. This is a high-end estimate: it is very likely that corporations, in response to the federal-level tax impacts of the GILTI provision, will develop new tax avoidance strategies that will lower their GILTI tax exposure.

Preliminary analysis conducted by economists at the University of Pennsylvania using the Penn-Wharton Budget Model. See Appendix A of this report. Final results to be published in the near future.


Center on Budget and Policy Priorities, Off the Charts blogpost, Michael Mazerov, “Ensuring that Massachusetts Corporations Pay Their Fair Share”, November 13, 2019: https://www.cbpp.org/blog/ensuring-that-massachusetts-corporations-pay-their-fair-share

See Appendix A of this report, a summary of the preliminary results of the Penn-Wharton analysis of U.S. and MA-specific GILTI.

MassBudget’s calculation runs as follows:

- $12.5 billion of MA-apportioned GILTI x 0.50 (the 50 percent deduction) = $6.25 billion of corporate GILTI taxable by the Commonwealth
- $6.25 billion x 0.08 (the 8 percent rate at which most corporate income is taxed in MA) = $500 million

Massachusetts lawmakers approved an amendment to an FY 2018 supplemental budget that redefined GILTI as dividend income, a type of corporate income that in Massachusetts enjoys a 95 percent deduction. This technical redefinition of GILTI means that, in practice, only 5 percent of taxable GILTI actually is subject to the state corporate income tax, as opposed to the 50 percent that would be taxed if Massachusetts conformed to the federal approach.

See calculation in Endnote #13, above.


Under the current U.S. “territorial” or “water’s edge” tax system, profits reported by a corporate tax filer as having been generated overseas are not included in the standard federal calculation of the corporation’s taxable U.S. income. Because most state corporate tax systems use federal taxable income as their base, income shifting directly reduces both federal and state tax collections.


TaxAnalyst, State Tax Notes, Shankse & Gamage, “Why States Should Tax the GILTI”, March 4, 2019 (see pg. 751): https://www.repository.law.indiana.edu/facpub/2746/

TaxAnalyst, State Tax Notes, Shankse & Gamage, “Why States Should Tax the GILTI”, March 4th, 2019 (see pg. 752): https://www.repository.law.indiana.edu/facpub/2746/

... (In identifying the scope of the problem and the income shifted, we agree that it is useful to look for anomalies. For example, there are many jurisdictions where U.S. corporations report profits that constitute multiples of that jurisdiction’s
GDP; it is clearly impossible that the reported income was actually earned in that jurisdiction in a real sense. Another — and related anomaly — is that assets and people in some jurisdictions seem to produce gigantic amounts of reported income relative to similar assets in other jurisdictions. Of course, workers in these jurisdictions are not really more profitable; the excess profitability is just an artifact of income shifting.” (See also footnotes accompanying this quote in the original article.)

21 Center on Budget and Policy Priorities, Off the Charts blogpost, Michael Mazero, “Ensuring that Massachusetts Corporations Pay Their Fair Share”, November 13, 2019: https://www.cbpp.org/blog/ensuring-that-massachusetts-corporations-pay-their-fair-share


22 The operating assumption here is that a routine rate of return on investments that exceeds 10 percent is very unlikely — instead, it is far more likely that the additional profit comes not from actual economic activity taking place in low-and no-tax jurisdictions, but from income that corporations have shifted onto the books of subsidiaries they have located in foreign tax havens precisely for the purpose of reducing their tax liabilities.

23 The evidence suggests that roughly half of global research and development — i.e., profit-generating international investment — is funded by U.S. corporations. This estimate helps inform the allocation in the GILTI provision for half of a corporation’s total GILTI to be assigned to the U.S. for tax purposes.


24 Corporations are given a credit against their U.S. taxes worth 80 percent of any taxes they may have paid to foreign jurisdictions on this GILTI. This 80 percent credit only affects a corporation’s federal taxes. The credit does not apply at the state level. Foreign tax credits have long been a feature of the federal tax system, and have never been a feature of state taxation, since the credit has already been applied against federal taxes.


27 See, for example, Adams Express Co. v. Ohio State Auditor, 165 U.S. 194 (1897).


30 See, for example, Container Corp. v. Franchise Tax Board, 463 U.S. 159, 170 (1983)
Preliminary static estimates of Global Intangible Low-Taxed Income, 2020-2030

January 24, 2020

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Corporate:

Parameters:

| Enactment Date | NA |
| Window         | Tax Years 2021-2030 |
| Estimate Type  | STATIC |
| Notes          | Estimates do not include behavioral responses. |

Summary
PWBM projects that U.S. multinational corporations will generate about $5.5 trillion in Global Intangible Low-Taxed Income over the 10-year period from 2021 to 2030. PWBM estimates that about 3 percent of this amount, or $160 billion, would be apportioned to Massachusetts. All estimates are preliminary and reflect ongoing work at PWBM.

Projections, 2020-2030
Table 1 presents PWBM’s projections of total Global Intangible Low-Taxed Income (GILTI) reported by all U.S. multinational corporations and the amount that would be apportioned to Massachusetts from 2020 to 2030.

PWBM projects that U.S. corporations will generate $430 billion in GILTI in 2020, about $12 billion (or 3 percent) of which would be apportioned to Massachusetts. Over the 10-year period from 2021 to 2030, PWBM projects that U.S. corporations will generate more than $5.5 trillion in GILTI in total, $160 billion of which would be apportioned to Massachusetts.

PWBM’s preliminary projections are on a static basis, meaning that they do not account for tax planning responses to the inclusion of GILTI in gross income beginning in 2018. Incorporating these responses would reduce the amount of GILTI reported by multinational corporations, especially in later years. PWBM will release revised estimates that account for such responses in the coming weeks.
Table 1. GILTI apportioned to Massachusetts

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Note: Projections are on a static basis.

Assumptions
Projections of growth in U.S. corporations’ foreign income are based on the Congressional Budget Office’s August 2019 economic baseline. Other factors that affect the amount of GILTI are projected by PWBM or held constant at recent levels.

Estimates of GILTI by NAICS industry are apportioned to Massachusetts based on the state’s shares of total U.S. sales, payroll, and property in each industry. For most industries, GILTI is apportioned using a weighted average of the three shares, with the sales share double-weighted. For manufacturing industries and mutual funds, GILTI is apportioned based on the sales share only. Estimates of the three factors by industry are held constant throughout the projections.

Sources
PWBM’s estimates for all U.S. multinational corporations are based primarily on data collected from federal corporate income tax forms – including Form 5471, Form 8975, Form 1118, and Form 1120 – and on a mandatory survey of U.S. multinationals conducted by the Bureau of Economic Analysis (BEA). Data from these sources are generally available through 2016. Projections through 2030 and estimates of GILTI are from PWBM’s tax microsimulation model, which simulates corporate income tax returns for a representative synthetic sample of U.S. corporations.

PWBM’s estimates of Massachusetts’ shares of sales, payroll, and property by industry are based on data from BEA, including the input-output accounts, GDP by state, wages and salaries by state, and the fixed asset accounts. Data from these sources is available through 2017.