

Few Answers On State Taxing Of Individuals' GILTI Inclusions

By **Peter Baum and Chris Migliaccio** (December 18, 2019, 5:59 PM EST)

With the end of 2019 tax filing season, all calendar-year taxpayers have finally filed their first returns reporting Global Intangible Low Taxed Income inclusions. GILTI, enacted as part of the Tax Cuts Jobs Act,[1] affects all U.S. taxpayers who are U.S. shareholders[2] of controlled foreign corporations.[3]

While the name would suggest it targets income from intangibles located in low-taxed jurisdictions, GILTI actually functions as a minimum tax on foreign earnings of U.S. shareholders, with a reduction for returns on tangible assets and a limited high-tax exception only existing in proposed regulations at the moment.[4]

U.S. shareholders of profitable foreign businesses have gotten to see the impact of GILTI at the federal level, but at the state and local level, they may still have questions about the real impact of GILTI. Much has been made of the struggles of state taxing authorities to provide guidance on how taxpayers should treat federal GILTI inclusions for state purposes.

Direct instruction has been slow to come, and what little has been provided has frequently left unanswered questions,[5] particularly as it relates to the unique situation individual taxpayers face as it relates to their GILTI inclusions.

Individuals generally bear a much higher rate of tax on GILTI than corporations. Federal tax rules provide an option to reduce that burden with a Section 962 election, but whether use of that option is respected for state purposes is still (mostly) an open question.

This article outlines the difficult situation individuals with GILTI inclusions find themselves in, the impact of the Section 962 election and the importance of determining whether the election can apply for state tax purposes.

GILTI for Individuals

Although GILTI is included under Subpart F, the calculation is performed at the U.S. shareholder level, rather than the controlled foreign corporations level.

A U.S. shareholder of CFCs has a GILTI inclusion equal to their "net tested income" (their pro rata share



Peter Baum



Chris Migliaccio

of “tested income” from CFCs, reduced by their pro rata share of “tested losses” of other CFCs) over their “net deemed tangible income return” (a deemed return from tangible assets held by CFCs with tested income, plus certain interest expense).[6]

While the calculation of GILTI inclusion for individual and corporate taxpayers is the same, that’s where the similarities end. While corporations may reduce their GILTI inclusion by the 50% Section 250 deduction, that deduction is not available to individuals.[7] Further, corporations are now subject to a flat 21% rate on income,[8] while individuals are subject to graduated rates with a maximum of 37%.[9]

As a result, an individual with the same GILTI inclusion as a corporation would pay a rate of tax almost four times the amount a corporation would pay (37% vs. 10.5%). Further, corporations have access to 80% of the indirect foreign tax credits of CFCs that relate to the GILTI inclusion, potentially reducing their GILTI inclusion to zero; individuals do not.[10]

Enter the long-unused Section 962 election, which allows an individual to be treated as a corporation for federal income tax purposes relating to GILTI and Subpart F.[11] The Section 962 election allows an individual to take the Section 250 deduction on its GILTI inclusion, as well as subjecting it to the lower corporate rate.

The Section 962 election also allows an individual to make use of indirect foreign tax credits relating to the GILTI inclusion. The election is made on a yearly basis.

Not all individuals with a GILTI inclusion will want to make the election. For example, if there is intent to bring income from foreign corporations back in the short-term, the Section 962 election reduces the tax rate on GILTI inclusions — but also subjects the income to a second level of tax when the income is distributed to the individual (although the tax paid on the initial inclusion reduces the taxable distribution amount as previously taxed income).

However, it certainly has become, and will continue to be, a widely used mechanism for individuals to avoid the onerous effect of GILTI.

GILTI at the State Level

The treatment of GILTI at the state level varies widely. For taxpayers in states that don’t conform to the current Internal Revenue Code, such as California, or do not have a corporate or individual income tax, such as Nevada, GILTI is a nonissue. In other states (those providing separate reporting for corporations), constitutional questions about conformity still linger.[12]

In states that do conform, there are two key questions in determining the inclusion amount. First, is the Section 250 deduction respected for state purposes? For corporations, if the state conforms to taxable income on Line 28 of the Form 1120 (Taxable Income before NOL and “Special” Deductions), the Section 250 deduction would not be included unless the state explicitly has indicated that it will be included.

If the state conforms to Line 30 of the Form 1120 (Taxable Income), the Section 250 deduction is automatically included. For individuals, conformity usually relates to Line 7 of Form 1040, adjusted gross income, which would come before the Section 250 deduction is taken into account for those making a Section 962 election (via Schedule 1 of the Form 1040, Other Income).

Second, does the state provide a dividends received deduction for foreign dividends? As GILTI is

included in income via Subpart F, it shares the same treatment as Subpart F for state purposes. Thus, corporations may get a 95% exclusion of GILTI income, significantly reducing the impact of GILTI for state purposes.

However, states that provide a foreign dividends received deduction generally do not do so for individuals. As a result, an individual would have a GILTI inclusion 20 times higher for state purposes than a corporation with the same income. In those states, whether the Section 962 election is respected could be a key driver in determining the individual's state tax liability.

Treatment of 962 Election at the State Level

While the importance for individuals of whether the Section 962 election is respected may be high, guidance on the issue has been scarce. Only two state and local taxing authorities have explicitly commented on the treatment of Section 962 elections.

New York City indicated in September^[13] that it would respect a Section 962 election. For individuals making the election, the Section 250 deduction should be calculated the same way it would be for federal income tax purposes, and GILTI income of an individual who made the election would be treated as corporate income.

Georgia, on the other hand, has made clear that they will not respect the Section 962 election. While Georgia uses federal adjusted gross income as the starting point for computing an individual's state income tax, which would include GILTI for individuals, it feels the Section 962 election relates to how tax is paid.

Georgia does not conform to federal rules on how tax is paid, and thus does not respect the Section 962 election. As a result, Georgia individual taxpayers who make the Section 962 election will need to include their GILTI income as individuals, and will not have access to the Section 250 deduction, which Georgia allows a corporation to take. However, the gross up relating to foreign taxes paid found on the federal return because of the Section 962 election may be subtracted for Georgia purposes.^[14]

That leaves a number of states where GILTI is definitely included, and where a foreign dividends received deduction does not apply for individuals, but where the applicability of the Section 962 election has not been directly addressed. As a general principle, federal elections are respected for state tax purposes unless the state makes explicit that they are not.

Thus, practice is to assume that the election is respected for state purposes, and to calculate the GILTI inclusion at the state level as if the individual were a corporate taxpayer. However, there remains the possibility that, as states begin to examine the tax amounts received from GILTI for the 2018 tax year, more states will provide guidance similar to Georgia's.

Conclusion

The Section 962 election has become a key part of managing the GILTI inclusions for individuals on the federal level. At the state and local level, little guidance has been provided on whether the election is respected, leaving taxpayers to rely on general principles regarding the treatment of federal elections at the state and local level.

Peter D. Baum is a partner and Chris Migliaccio is a senior manager of international tax at PKF O'Connor Davies LLP. Migliaccio is also the host of the World of Tax podcast.

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[1] PL 115-97, 12/22/2017.

[2] Section 951(b).

[3] Section 957(a).

[4] For a discussion of the proposed high-tax exception, see High-Taxed Global Income Exclusion May Be Too Narrow, Robert Kiggins, Law360, July 10, 2019.

[5] See NJ Tax Stop: GILTI Guidance Gaps Need Filling, Philip Hirschfeld, Law360, Oct. 16, 2019.

[6] Section 951A(b).

[7] Section 250(a)(1).

[8] Section 11.

[9] Section 1.

[10] Section 960.

[11] Section 962.

[12] GILTI May Still Create Constitutional Issues For States, Natalie Olivo, Law360, Oct. 18, 2019.

[13] New York City Finance Memorandum No. 18-10, Sept. 2, 2019

[14] Policy Bulletin IT 2018-01 (Revised), Exclusion for Dividends from Sources Outside the United States, Aug. 13, 2019.