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# *Current Developments in State and Local Tax*

## *Worldwide Unitary Tax to Settle States' Unfair Treatment of GILTI—Is this a "Peace in Our Time" Moment?*

By Greg Rottjakob and Joseph Schmidt

State and local tax (SALT) luminaries express empathy toward taxpayers aggrieved over unfair state taxation of global intangible low-taxed income (GILTI), intoning that this is just another example of "rough Justice" dealt out by the Supreme Court in *Container*.[1] The murky nature of proving distortion likely leads taxpayers to settle rather than litigate challenges to extraterritorial taxation due to distortion. Where distortion is concerned, there is merit to finding middle ground in negotiating settlements, but the fact of the matter is that states taxing GILTI are "guilty" of facial discrimination. As the Supreme Court explained in *Kraft*, states have no defense once proof of facial discrimination is successfully entered into the trial record.[2] Thus, we are at a "seize the day" moment in history where taxpayers need to push litigation to ultimately resolve what remains in disagreement since 1983 by the Reagan administration's Worldwide Unitary Taxation Group—the inclusion of income from foreign subsidiaries in the water's-edge tax base.

Yes, the holding in *Mobil v. Vermont* allows states to include income from foreign subsidiaries in the income base.[3] But the Court, in an opening paragraph to the opinion, made clear that such an inclusion is qualified:

> In keeping with its litigation strategy, appellant has disclaimed any dispute with the accuracy or fairness of Vermont's apportionment formula … Instead, it claims that dividends from a "foreign source," by their very nature, are not apportionable income. This election to attack the tax base, rather than the formula, substantially narrows the issues before us. In deciding this appeal, we do not consider whether application of Vermont's formula produced a fair attribution of appellant's dividend income to that State. Our inquiry is confined to the question whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad

> that precludes, as a constitutional matter, state taxation of that income by the apportionment method.[4]

We believe this was a hint from the majority that *Mobil* should have pursued the issue of fair apportionment. Justice Stevens dissented because he believed it was fundamentally unfair for the state to include dividends from foreign subsidiaries in a company's taxable income without also including a fair share of the subsidiaries' property, payroll, and sales in the apportionment formula. In his view, if the foreign subsidiaries are considered part of a unitary business, then the underlying business activity, *i.e.*, factor representation, should be fully reflected in the tax calculation—not just the income base.[5]

Just three years later, the Supreme Court opinion in *Container* echoed Stevens's dissent in *Mobil*:

> Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair[6] … Besides being fair, an apportionment formula must also not result in discrimination against interstate or foreign commerce.[7]

This means fundamental fairness—including income from unitary foreign subsidiaries without allowing full upstream apportionment factor representation is fundamentally unfair and equates to another example of the facial discrimination that the U.S. Supreme Court chose not to tolerate in *Kraft v. Iowa*. The *Container* Court then went on to discuss the tolerance for mild distortion that results from using apportionment as a saccharine substitute for precise accounting, dredging up *Hans Rees' Sons* (*i.e.*, roughly four to five times disproportionate with the facts) as the standard for proof of distortion.[8]

It is true that underrepresenting unitary foreign income inclusion in the apportionment factor denominators may lead to distortion, but *Kraft* tells us that once facial discrimination is proven to exist, proof of distortion is unnecessary. *Kraft* provides additional analysis making it clear that once facial discrimination is successfully proven, states have no defense, and the offending treatment of foreign commerce must be stricken.[9]

The point being made is that framing of the issues while threatening to litigate must include proof that there is facial discrimination. Making a distortion argument is unlikely to make a state feel "threatened" by taxpayer litigation. On the other hand, learned counsel on the other side will likely entertain better than "worldwide unitary tax" settlement offers when they recognize that, on the merit, they have less than a 50% chance of prevailing.

Proving facial discrimination is relatively simple. Simply model the state treatment of GILTI and compare the results with both water's-edge and worldwide unitary tax sans foreign inclusion. Get the state to stipulate to the model and then move to summary judgment on the premise that the facially discriminatory taxing scheme must be struck down per *Kraft*.

## What Is GILTI?

Let us cut to the chase by paraphrasing the statutes under Code Sec. 951A:

1. Aggregate the sum of profits (net of income tax) and losses of all controlled foreign corporations ("CFCs") which, for practical purposes equate to unitary foreign subsidiaries for the vast majority of publicly-held or privately-held companies with a global reach.
2. Subtract an allowance of 10% invested by the CFCs in tangible production assets, if any, and note that this is gone with the modifications to GILTI by the "One Big, Beautiful Bill" along with a name change to "Tested Income" in place of GILTI.
3. Subtract subpart F income, if any.

The result is GILTI income. Thus, states piggy-backing off the Code to include GILTI are, in effect, including nearly 100% of global income in the water's-edge unitary base. Okay, I hear you saying that nearly all states taxing GILTI allow the GILTI-related Code Sec. 250 deduction. My question for you is whether that difference is legally significant when it comes to facial discrimination. *Kraft* says that the magnitude of facial discrimination is irrelevant. Whether 5% or 50% of GILTI inclusion occurs with little to no apportionment representation is perhaps relevant when proving distortion. It comes into play also in assessing whether challenges to a state regime are worthwhile, but from the perspective of facial discriminatory effect the magnitude means nothing.

## Statutory Issues to Partial or Full GILTI Inclusion

The manner in which states adopted or incorporated the Internal Revenue Code (IRC) received much attention after the passage of the Tax Cuts and Jobs Act (TCJA) in 2017. The analysis focused on categorizing IRC adoption into two-dimensional buckets: rolling conformity,

static date adoption, and selective IRC section adoption. Another dimension that was not getting the appropriate attention in the aftermath of TCJA is the essence of GILTI, especially in light of the *Moore* decision. [10] Justice Kavanaugh authored the majority opinion in which the Supreme Court concluded that Congress, when recognizing income of CFCs at the shareholder level, has opted to treat the CFCs as passthrough entities rather than to treat them as entities separate from shareholders for income tax purposes.[11] Query why this holding would not bind states? In circumstances where states piggy-back off of IRC adoption to include GILTI, *Moore* would require states to provide full factor relief in exactly the same manner that the vast majority of states treat partnerships:

> The MRT ["Mandatory Repatriation Tax"] attributes the undistributed income of American-controlled foreign corporations to their American shareholders, and then taxes the American shareholders on that income. By doing so, the MRT operates in the same basic way as Congress's longstanding taxation of partnerships …[12]

> … In short, the Moores cannot meaningfully distinguish the MRT from similar taxes such as taxes on partnerships, on S corporations, and on subpart F income. The upshot is that the Moores' argument, taken to its logical conclusion, could render vast swaths of the Internal Revenue Code unconstitutional. *See*, *e.g.*, 26 U. S. C. §305(c) (deemed stock distributions); §§446, 448 (accrual accounting); §701 (partnership taxation); §§951–965 (subpart F); §951A (pass-through tax on global intangible low-taxed income) …[13]

Arguably, the reference to GILTI in *Moore* is *dicta* because the issue before the Court involved Deemed Repatriation income under Code Sec. 965 (or MRT), but the holding makes clear that shareholder-level recognition of income generated by foreign subsidiaries equates to passthrough entity treatment by the IRC. Given the holding in *Moore*, characterization of GILTI as passthrough entity treatment is not a mere suggestion. Thus, the holding in *Moore* is binding on states adopting GILTI. Accordingly, passthrough entity treatment is not mere whimsy, but rather mandatory to the state statutory schemes that incorporate the IRC.

Passthrough entity treatment addresses factor relief head on, but ignores the economic reality that passthrough entity treatment is indirectly including foreign subsidiaries as members of the water's-edge filing group, which itself is prohibited directly.

## Conclusion

Whether a taxpayer opts to argue the state statutory conundrums of IRC adoption of GILTI, or the alternative that GILTI is provable facial discrimination, there is little incentive, other than micro-economic pragmatism, to concede GILTI challenges by agreeing to pay tax on a worldwide unitary basis. The impact of GILTI incremental tax annuities is too large to ignore. The Reagan administration threatened to pass legislation to abolish worldwide unitary taxation. The Reagan administration's Worldwide Unitary Taxation Group resulted in states agreeing to allow corporations to utilize water's-edge unitary tax rather than worldwide, but neither states nor taxpayer representatives that served on the Worldwide Unitary Taxation Group agreed on the matter of taxing foreign subsidiary-sourced income by the water's-edge filing group.[14] Because GILTI—now "Tested Income"—is tantamount to creating a quasi-worldwide unitary income base, taxpayers must take a harder line in the challenges being presented to states regarding fundamentally unfair treatment of GILTI.



### ENDNOTES

1 *Container Corp. v. Franchise Tax Bd.*, SCt, 463 US 159, 103 SCt 2933 (1983).
2 *Kraft General Foods, Inc. v. Iowa Dep't of Rev. and Finance,* SCt, 505 US 71, 112 SCt 2365 (1992).
3 *Mobil Oil Corporation v. Comm'r of Taxes of Vermont,* SCt, 445 US 425, 100 SCt 1223 (1980).
4 *Mobil Oil Corporation v. Comm'r of Taxes of Vermont,* SCt, 445 US 425, 434, 100 SCt 1223 (1980).
5 *Mobil Oil Corporation v. Comm'r of Taxes of Vermont,* SCt, 445 US 425, 461, 100 SCt 1223 (1980).
6 *Container Corp. v. Franchise Tax Bd.*, SCt, 463 US 159, 169, 103 SCt 2933 (1983).
7 *Container Corp. v. Franchise Tax Bd.*, SCt, 463 US 159, 170, 103 SCt 2933 (1983).
8 *Id.*
9 *Kraft General Foods, Inc. v. Iowa Dep't of Rev. and Finance,* SCt, 505 US 71, 81, 112 SCt 2365 (1992).
10 *C.G. Moore,* Dkt. 22-800, SCt, 602 US 572 (2024).
11 *C.G. Moore,* Dkt. 22-800, 1, SCt, 602 US 572 (2024).
12 *C.G. Moore,* Dkt. 22-800, 22, SCt, 602 US 572 (2024).
13 *C.G. Moore,* Dkt. 22-800, 21, SCt, 602 US 572 (2024).
14 JGR Unitary Taxation, Ronald Reagan Presidential Library Digital Library Collections (1985).