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Mr. Joe Crosby
Executive Director
STAR Partnership
515 King Street, Suite 300
Alexandria, Virginia 22314

Dear Mr. Crosby:

This letter sets forth our view that New York State and City should decouple from certain of the provisions enacted by the Tax Cuts and Jobs Act at the federal level. As a preliminary matter, however, we would like to note that the New York legislators should be commended for proposing language that would not only explicitly provide that New York State and City will decouple from the provisions including deemed repatriated foreign earnings in the tax base, but also proposing language ensuring that no taxpayer will suffer a penalty for under-withholding its estimated taxes due to potential attribution of interest to the excluded deemed repatriated foreign earnings.

ISSUES: We now turn to three other areas of federal tax reform: the taxation of global intangible low-taxed income ("GILTI"); the new limitation imposed on the deductibility of interest expense; and the new limitation on the deductibility of FDIC premiums. We understand that the New York State Senate Bill (S. 7509) contains language decoupling from all three of these provisions. This language was not in the Governor's Bill, nor in the New York State Assembly Bill (A. 9509).

RECOMMENDATION: For the reasons set forth below, we agree that the language included in the Senate Bill decoupling from GILTI (by including it in the statutory definition of "exempt income"), the interest expense limitation, and the limitation on the deduction of FDIC premiums should be included in any final legislation passed in New York, subject to the technical corrections being advanced by the Business Council of New York State, Inc.

GILTI: *Long-Standing Policy to Exclude Income Generated by Foreign Subsidiaries:* New York State and City have had a long-standing policy of excluding income deemed to be received by a taxpayer from the foreign operations of its foreign subsidiaries – Subpart F income – when those foreign subsidiaries ("CFCs") are not included in a combined return with the taxpayer. New York State and City should not change this policy merely because the federal government has created a new category of income deemed to be received from the foreign operations of foreign subsidiaries -- the new federal "global intangible low-tax income" ("GILTI").

By way of background, GILTI was put in place effective for years after the one-time mandatory repatriation transition tax. Very generally, the GILTI provision is in essence a so-called minimum tax on the earnings of a U.S. corporation's foreign subsidiaries, with GILTI being determined by aggregating *all* of the subsidiaries' earnings; thus, GILTI includes all of the income generated by the foreign subsidiaries' from their active trade or business operations, not just income generated by intangibles. One key point is that for federal tax purposes, the U.S. corporation reporting the GILTI can avoid this minimum tax through the use of foreign tax credits if it has an aggregate foreign effective tax rate of approximately 13% currently and of approximately 16% for years beginning in 2026.

New York has historically not taxed income generated by active trade and business activities of foreign operations and should not begin to tax that income now simply because such income comes into the federal return as GILTI. Further, if New York rejected jurisdiction over Subpart F income, which is income "deemed" received by a U.S. taxpayer from its foreign subsidiaries due to income streams like interest that could be easily moved to favorable taxing jurisdictions, it certainly should not exert jurisdiction over GILTI derived from the active trade and business of foreign operations.

GILTI Inclusion Would Result in Double-Taxation of Income Generated in High-Tax Foreign Jurisdictions: At the federal level, not only is the method of taxing GILTI structured in a manner designed to reduce the taxable rate imposed on any GILTI inclusion, it is also designed in a manner intended to tax the CFCs' earnings only to the extent such earnings are attributable to low-tax countries in which little or no tax is paid on the GILTI. The method designed to implement the exclusion from tax of GILTI earned in high-tax jurisdictions is by taking into account tax payments made by the CFCs to foreign countries through foreign tax credits.[1] New York State and City, however, do not take into account foreign tax credits in determining their taxable base. While it is well-accepted that most states do not give any credit with respect to general foreign tax credits paid, the lack of a mechanism to exclude GILTI paid to high-tax jurisdictions would result in New York State and City taxing GILTI that is attributable to high-tax countries, essentially taxing such income twice.

Accordingly, if New York State and City were to include GILTI in a taxpayer's base without making some adjustment to account for the fact that such income may be subject to substantial foreign taxes where earned, New York State and City would be exceeding the intent and focus of the federal legislation, and merely indiscriminately penalizing taxpayers with CFCs without any regard for whether those CFCs are operating in high- or low-tax jurisdictions. It should be noted

[1] *See* Conference Report to Accompany H.R. 1 (2017), p. 643. ("For any amount of GILTI included in the gross income of a domestic corporation, the corporation's deemed-paid credit equals 80 percent of the product of the corporation's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued, with respect to tested income, by each CFC with respect to which the domestic corporation is a U.S. shareholder").

that this method is inapposite to the manner in which New York State and City currently require the add-back of related party royalty payments, with an exception to the add back when the royalty payment is subject to substantial tax by a foreign country. Tax Law § 208.9.(o)(2)(B) ; Administrative Code § 11-652.8.(n)(2)(ii).

Apportionment Complexity: Inclusion of GILTI will add complexity to New York State and City apportionment provisions. If GILTI is deemed to be included in a taxpayer's income base as business income, a proper method of including such income in the receipts factor will need to be determined. Because GILTI is income from the conduct of active foreign operations, any rules for sourcing GILTI would need to take into account the actual foreign operations being conducted. This could be very difficult because GILTI represents the excess of certain income generated by a taxpayer's CFCs, as determined on an aggregate basis. That the GILTI is determined on an aggregate basis, and that GILTI represents the excess of certain income generated by those aggregated CFCs, would make it complex for the taxpayer to determine (and New York State and City to audit) the specific activities generating the GILTI income. For many taxpayers, however, this factor representation should result in all of the GILTI being included in the denominator and none in the numerator. This could result in even less income being attributable to New York State and City than if the GILTI were not included in both the tax base and the apportionment formula, therefore clearly contradicting the impact that New York State and City would be intending by including GILTI in the tax base.

Potential Unconstitutionality: Inclusion of GILTI in the tax base would also be potentially unconstitutional because income from GILTI is by definition income from foreign subsidiaries. To include such income from subsidiary operations conducted outside of the U.S. but not income from subsidiary operations conducted within the U.S. could violate the Foreign Commerce Clause. While the income of U.S. subsidiary operations would effectively be included in the tax base if such subsidiary is included in a combined return with its parent, not all U.S. subsidiaries will be included in a combined return with their parent either because the parent and the subsidiary are not engaged in a unitary business or because the subsidiary is a different type of company – such as an insurance company or certain utility companies – than the parent.

Interest Expense Limitation: Adopting the new federal interest expense limitation that has been put in place for federal income tax purposes will result in many complications for New York State and City corporate franchise tax purposes.

Background: The purpose for which Congress adopted the federal interest expense limitation will not be served by implementing such limitation at the state level. The limitation was put in place as an anti-earnings stripping tool that was meant to address the supposed propensity for multinational taxpayers to incur interest expense within the U.S. in order to reap a higher tax benefit for deductions used within the U.S.[2] *Accordingly, there is no question that the business*

[2] The new provision is similar to one of the rules set out by the OECD as part of its base erosion and profit shifting ("BEPS") initiative. *See*, OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4.

interest expense being disallowed under the new federal limitation is valid business interest expense. Instead, the rules were put in place to dissuade companies from placing what U.S. Congress deemed to be an excessive portion of their interest expense within the U.S.

Furthermore, we understand that the addition of the interest expense limitation was also linked to the enactment of the provisions allowing for 100% expensing of certain depreciable property, with the rationale being that taxpayers should not be eligible for a double deduction when they borrow funds for the purpose of buying depreciable property that can be expensed. New York State and City decouple from the expensing provisions; accordingly, they should also decouple from the interest expense limitation.

Carryforwards of Suspended Interest Expense: At the federal level, interest is not merely disallowed if it is subject to the interest disallowance. Instead, the taxpayer is allowed to carryforward the disallowed interest indefinitely for use in future years when it is not subject to the interest expense disallowance. If New York State and City do decide to adopt the interest expense limitation, there will now need to be a new category of carryforwards to be tracked -- suspended interest. In addition, issues would arise, as with NOL carryforwards, whether to allow use of the suspended losses in future years based on the taxpayer's apportionment formula in the year the interest expense was actually paid or the year in which the interest expense was used. Furthermore, in the case of a combined group, issues would arise concerning to which entity the suspended interest would be attributed if the composition of the group changed -- for example, if corporations join or leave a New York State or City combined group.

Computation of the Interest Limitation at the State Level: While it is not yet certain whether the interest limitation will be determined at the consolidated group level for federal income tax purposes, legislative history indicates that was the intended method to be used.[3] The members of a New York State or City combined group, however, can vary from the members of the federal consolidated group, resulting in the need for additional computations to be performed. Computation of the applicable interest expense limitation based on the members of the New York State or City combined group can have a much different result than at the federal level. For example, a group of corporations that is consolidated at the federal level and that does not have any disallowed interest at the federal level could end up with interest disallowance in New York State or City. Thus, for New York State and City purposes, there may be a group that technically has interest disallowed even though they do not have excessive interest expense in the U.S.

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[3] *See* Conference Report to Accompany H.R. 1, at 386 (2017) ("In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level."). Computation of the limitation at the consolidated group level makes sense because the computation to determine whether there is excess interest expense takes into account related party interest, but related party interest between members of the consolidated group will be eliminated and will not in any way increase the amount of interest being deducted at the federal level.

This could be a relative common occurrence because there are frequently disparities between the composition of the federal consolidated group and the composition of the New York State and City combined group because (a) foreign corporations are not included in the federal group but are included in New York State and City combined returns; (b) non-unitary corporations can be included in a federal consolidated group but do not have to be included in New York State and City combined returns; and (c) certain insurance companies and telecommunication companies are included in federal consolidated returns but cannot be included in a combined return with general corporations.[4]

Even more disturbingly, if members of a federal consolidated group file as part of two groups in New York, one group could have an interest expense disallowance while the other group could be paying tax on income received from the first group. This is patently unfair and bad tax policy. There is no easy fix for such inappropriate treatment because the disallowed interest is not directly attributed to specific lending transactions. Thus, a method would need to be devised to attribute the disallowed interest expense of the combined group between its related and unrelated-party interest expense so that the combined group receiving the related party interest could exclude such interest income from its tax base. To add further complexity to the issue, New York State and City may want to institute a carryforward of such related-party interest income so that when the related interest expense is deducted by the paying combined group, the interest income would be added back to the receiving combined group. This would result in the need to track several items for New York State and City tax purposes – the suspended interest expense deemed to be related-party interest expense by year, the suspended interest expense deemed to be unrelated-party interest expense by year, and the suspended related party interest income by year. Again, further complications would arise to the extent the compositions of the combined groups change.

FDIC Fees: As provided in the Senate Bill, New York State and City should decouple from the new federal limitation imposed on the deduction of FDIC fees for certain banks. The federal provision disallowing a deduction for these fees was included purely as a means of raising revenue to off-set other provisions that reduced the overall amount of corporate federal income taxes that will be paid to the federal government. Because taxpayers are not benefiting from an overall tax reduction in New York State and City, there is no rationale for limiting the

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[4] This problem is especially convoluted for telecommunications companies because the telecommunications companies that can be included in a combined return with general corporations vary between New York State and City; corporations that are principally engaged in a telecommunications business cannot file as part of a combined group of general corporations in New York State, while only regulated telecommunications companies cannot be so included in New York City.

deductibility of FDIC fees. Furthermore, this provision negatively impacts institutions with a significant presence in New York.

Sincerely,

Alysse K. McLoughlin /jgh

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