JANET T. MILLS
GOVERNOR

STATE OF MAINE
MAINE REVENUE SERVICES
P.O. BOX 1060
AUGUSTA, MAINE
04332-1060

ADMINISTRATIVE & FINANCIAL SERVICES

KIRSTEN LC FIGUEROA
COMMISSIONER

MAINE REVENUE SERVICES

JEROME D. GERARD
EXECUTIVE DIRECTOR

January 14, 2022

Senator Benjamin M. Chipman, Co-Chair
Representative Maureen Fitzgerald Terry, Co-Chair
Joint Standing Committee on Taxation
100 State House Station
Augusta, ME 04333-0100

Dear Committee Co-Chairs:

Pursuant to 36 M.R.S. § 5200-A, sub-§ 1(EE), I have enclosed the Study of the Foreign Derived Intangible Income Deduction Addition Modification. Please feel free to contact me if you have any questions about this report.

Sincerely,

Jerome D. Gerard

Jerome D. Gerard

Enclosure
cc: Members of the Joint Standing Committee on Taxation
Kirsten LC Figueroa, DAFS Commissioner

Study of the Foreign Derived Intangible Income Deduction Addition Modification

Report Prepared for the
Joint Standing Committee on Taxation

Department of Administrative and Financial Services
Maine Revenue Services
Office of Tax Policy

Introduction

"An Act To Make Supplemental Appropriations and Allocations for the Expenditures of State Government and To Change Certain Provisions of the Law Necessary to the Proper Operations of State Government for the Fiscal Year Ending June 30, 2021" ("Supplemental Budget" or "the Act"), P.L. 2021, c. 1, directed the Department of Administrative and Financial Services to study the income modification required pursuant to the Maine Revised Statutes, Title 36, section 5200-A, subsection 1, paragraph FF of prior tax years beginning on or before December 31, 2020 regarding a taxpayer's foreign-derived intangible income deduction ("FDII") claimed pursuant to the federal Internal Revenue Code of 1986, Section 250(a)(1)(B) and the effect of decoupling from that deduction. The bill also amended the addition modification to decouple from the federal FDII deduction, thereby disallowing the deduction for Maine income tax purposes.

When performing the study, the Supplemental Budget specifically directs Maine Revenue Services ("MRS") to determine:

1. Whether the deduction is being used by any Maine-based businesses;
2. The effectiveness of the deduction in meeting the goal of encouraging corporations to file their taxes domestically;
3. The annual cost in revenue to the State by that deduction;
4. The annual revenue that would be generated by decoupling from the deduction; and
5. Whether there is some other deduction or incentive that would fulfill the purpose of the deduction in a more effective or efficient manner.

In addition, the Supplemental Budget directed Maine Revenue Services to report, with suggested legislation, to the Joint Standing Committee on Taxation no later than January 15, 2022.

Part EE of the Supplemental Budget refers to the Global Intangible Low-Taxed Income ("GILTI") deduction and the pre-Supplemental Budget addition modification of Title 36, §5200-A, sub-§1, ¶FF, which required an add-back of the federal GILTI deduction, but did not affect the federal FDII deduction. The inconsistent references make it unclear whether the study was to address GILTI, FDII, or both. A study of the legislative history suggests the report is intended to be on the FDII deduction repealed by the Supplemental Budget.[1] However, this report also includes a discussion of GILTI to provide a better understanding of the role that FDII plays. The report will not attempt to answer the specific determinations noted above as they relate to the GILTI deduction because Maine has not conformed to the federal GILTI deduction[2] and, as such, the questions are largely inapplicable and do not appear to be the purpose of the reporting requirement.

[1] See the summary to the adopted Committee Amendment "C-A" which states "Part DD requires Maine Revenue Services within the Department of Administrative and Financial Services to study the income modification that requires the add-back for Maine tax purposes of a taxpayer's deduction claimed pursuant to the federal Internal Revenue Code of 1986 from federal taxation for foreign-derived intangible income."

[2] Maine requires taxpayers to add back the federal GILTI deduction and then allows a state level GILTI subtraction for constitutional purposes; see the discussion of GILTI below.

Background

GILTI and FDII were both created by the federal 2017 Tax Cuts and Jobs Act ("TCJA").[3] To better understand the effect and purpose of this federal regime, it is helpful to begin with the pre-TCJA international tax landscape.

Historically, the United States imposed taxes on a worldwide income basis; that is, U.S. taxpayers were taxable on all income, including income in other countries. However, a key aspect of that worldwide income tax system was timing – when the income would be taxed. Under the pre-TCJA Internal Revenue Code ("the Code"), much of the potential U.S. federal tax on that foreign income was deferred. Domestic shareholders of foreign corporations were not subject to tax on earnings until they were repatriated, that is, paid as dividends to the U.S. shareholder. An important exception to the general rule of deferral is Subpart F income. Subpart F income under the Code is certain passive or easily mobile income. Subpart F income is not deferred but instead taxed when earned. Maine followed this federal system in taxing both dividends and Subpart F income associated with the State.

Under this pre-TCJA system, companies could indefinitely defer repatriating foreign income for tax purposes, thereby substantially lowering their effective tax rate. This created a significant incentive to shift profits oversees.

The TCJA moved toward a territorial tax where certain income earned in other countries is not subject to U.S. tax.[4] This is accomplished primarily by allowing a 100% "dividends received deduction" for certain foreign sourced dividends received by domestic corporations. However, Subpart F income continues to be taxed. In 2018, Maine conformed to this federal change, continuing to tax Subpart F income, but no longer taxing these foreign sourced dividends associated with the State – thereby ending an existing revenue stream.[5]

While the TCJA generally moved the country toward a territorial system, it continued some aspects of worldwide taxation – focusing those aspects on income that was most subject to abuse. This included the continued taxation of Subpart F income and the newly created taxation of GILTI.

The purpose of GILTI is to tax global "intangible income" – income which might be easily shifted to other jurisdictions – that is subject to a low tax abroad. This is done by allowing a 10% rate of return on the tangible property located in a foreign jurisdiction that is not subject to taxation. Income over this 10% threshold is deemed intangible income subject to immediate taxation – that is, U.S. shareholders of

[3] *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*, Pub. L. No. 115-97 (2017), also known as the Tax Cuts and Jobs Act.

[4] As part of this transition, the TCJA applied the so-called "transition tax" or "repatriation tax" in which the income deferred under the prior system was taxed immediately at a reduced rate. Maine conformed to this transition tax, with an 80% state subtraction modification, raising an estimated $39 million.

[5] *An Act To Conform to the United States Internal Revenue Code of 1986 and Provide Tax Relief to Maine Families*, P.L. 2017, c. 474, pt. A, §1.

certain foreign subsidiaries must include their pro rata share of the subsidiaries' GILTI in gross income, even if such amount is not actually distributed to the U.S. shareholder. Foreign taxes imposed on this income can offset, or entirely remove, the U.S. tax.

The mechanical application of the GILTI regime is somewhat complex but can be simply described as creating a minimum tax on foreign intangible income of 10.5% to 13.125%. This minimum rate is accomplished, in part, through the application of foreign tax credits and a federal rate-setting deduction.[6]

Maine conforms to GILTI with two important differences. First, the federal rate-setting deduction is removed through an addition modification. This deduction was used at the federal level to reach specific tax rates; because Maine sets its own tax rates and applies its own dividend-received subtraction modification, the federal deduction is unnecessary for Maine purposes. Second, the federal deduction is replaced with a new 50% subtraction modification applied to GILTI. This subtraction modification continues Maine's longstanding statutory requirement of providing a 50% subtraction modification for international dividends[7] and subpart F income. The same constitutional and apportionment concerns that underpin Maine's dividend received subtraction also apply to this GILTI subtraction. See the side box for a discussion of these constitutional and apportionment issues.

The FDII deduction provides a lower effective tax rate on "deemed intangible income" earned directly by a U.S. corporation from foreign sales. FDII is traditional U.S. sourced income that was taxed before and after the enactment of the TCJA. The deduction at the federal level is generally intended to encourage locating income-producing intangible assets in the U.S. by providing a similar tax rate for domestic corporations making foreign sales as GILTI provides for foreign subsidiaries making similar sales. Maine conformed to the federal FDII deduction for tax years beginning before January 1, 2020.

While the federal FDII deduction is designed to create parity with the federal GILTI deduction, this goal is not obtained at the State level

Apportionment

The Maine Corporate Income Tax is at its simplest when taxing a corporation that operates solely within the State. However, due to the nature of the modern economy, this is the exception. Most corporations operate both within and without the State, and often outside the United States.

The taxation of interstate corporations raises important concerns under the U.S. Constitution. Maine can only tax a portion of a corporation's income that is associated with the State. This portion is determined by looking at the corporation's total income and then apportioning it to the State based on where the corporation's sales occur.

The taxation of international companies raises additional concerns. Maine has a longstanding statutory requirement of allowing a 50% subtraction modification for certain international dividends and similar income, including Subpart F income and GILTI. These 50% subtraction modifications are one of the means available under Maine law to address the constitutional concerns and related apportionment concerns that exist in state taxation of international transactions.

[6] The federal rate-setting deduction is only available to corporations, not individual taxpayers. Taxpayers who choose to own an international business in a noncorporate form may elect corporate taxation.

[7] While international dividends are now largely exempt at the federal and State level, this 50% subtraction modification remains for those dividends still subject to federal and State tax.

because the State does not conform to the federal GILTI deduction.[8] Instead of aligning the taxation of GILTI and FDII, the FDII deduction was simply a tax incentive that rewards corporations for producing in the U.S. and selling abroad.

Unlike many of Maine's other tax incentives, the FDII deduction was not well targeted at economic activity occurring in Maine. Instead of awarding a tax incentive for activity occurring in Maine, the deduction was allowed for economic activity throughout the U.S. and apportioned to the State based on the corporation's sales in Maine. For example, a company that produced widgets in California and sold them throughout the world, including in Maine, could receive the FDII deduction.

While the vast majority of the tax expenditure was allowed based on economic activity occurring outside of Maine, some of the benefit did go to economic activity within the State.

Findings

When performing the study, the Supplemental Budget specifically directs Maine Revenue Services to determine:

1. Whether the deduction is being used by any Maine-based businesses;
2. The effectiveness of the deduction in meeting the goal of encouraging corporations to file their taxes domestically;
3. The annual cost in revenue to the State by that deduction;
4. The annual revenue that would be generated by decoupling from the deduction; and
5. Whether there is some other deduction or incentive that would fulfill the purpose of the deduction in a more effective or efficient manner.

In addition, the Supplemental Budget directed Maine Revenue Services to report, with suggested legislation, to the Joint Standing Committee on Taxation no later than January 15, 2022.

1. Whether the deduction is being used by any Maine-based businesses

A definition of a Maine-based business does not exist within Maine tax law. The Maine corporate income tax is apportioned using the location of a corporation's sales. In that sense, a Maine-based business could be any business that sells products into the State. However, the term is more commonly used to refer to businesses that have their headquarters in the State, who employ substantial numbers of employees or locate substantial amounts of capital in the State, or who have a historical connection with the State. This report assumes a "Maine-based" business fits the latter category, possessing at least some of these characteristics.

[8] While the State does offer its own GILTI deduction, that deduction addresses constitutional apportionment concerns that are inapplicable to FDII.

Some of the expenditure went to "Maine-based" corporations with international sales; however, the vast majority of the tax expenditure went to corporations that are not "Maine-based" within the assumptions used in this report of what is considered a "Maine-based" business.[9]

2. The effectiveness of the deduction in meeting the goal of encouraging corporations to file their taxes domestically

It appears that the Maine FDII deduction was not effective in encouraging corporations to file their taxes domestically because the Maine FDII deduction did not significantly affect the overall tax rate of the corporations receiving the deduction. This is due in part to Maine's lower top corporate income tax rate of 8.93%, as compared to the federal rate of 21%. But more importantly, this is caused by the low Maine apportionment factor for corporations receiving the deduction.[10] The small reduction in the overall tax rate that most corporations received could not reasonably be expected to affect taxpayer behavior in terms of locating economic activity or profits domestically.[11] This result is not surprising because Maine tax incentives, like other State policies, are generally expected to affect taxpayer behavior at the State level rather than the national level. Furthermore, the Maine FDII deduction was also not effective at encouraging taxpayers to locate economic activity or profits in the State because the amount of the tax incentive was not based on activity occurring in the State.

3. The annual cost in revenue to the State by that deduction

Maine Revenue Services does not have complete data to calculate the revenue loss from conforming to the FDII deduction. For tax years beginning prior to 2020, the deduction was not reported separately on the Maine income tax return.[12]

For tax year 2020 corporate income tax returns processed through January 3, 2022, 395 taxpayers have an increase in tax liability totaling $4.06 million due to decoupling from the FDII deduction.[13] The top 10 tax increases account for 58% of the total tax increase. These amounts do not represent a full year of returns because many corporations file on a fiscal year basis (i.e., their tax year does not begin on January 1st) and because corporations have nine and a half months after the end of their tax year to file

[9] One data point to consider is the number of corporations with a Maine address that had a FDII addition modification. For tax year 2020, that number is 5 or fewer. The exact number of corporations, and the amount of their addition modification, is too low to report due to taxpayer confidentiality thresholds.

[10] The average Maine apportionment factor, weighted by FDII addback, for corporations with a positive tax liability receiving the deduction was 0.165%. The federal FDII deduction of 37.5% could reduce the federal tax rate on FDII from 21% to 13.125% - a reduction of 7.875 percentage points. On the other hand, Maine's conformity to the FDII deduction could, for a corporation with a 0.165% apportionment factor, reduce the post-apportionment Maine tax rate on FDII from 0.0147% to 0.0092%.

[11] While it is clear that Maine's conformity to the FDII deduction broadly fails to encourage corporations to file their taxes domestically – or to locate economic activity in the U.S. – it is possible that it could impact a corporation with a significant Maine apportionment factor and significant international sales.

[12] In early 2020, the MRS, Office of Tax Policy sampled 2018 corporate returns of taxpayers filing on a calendar year basis to determine the amount of the FDII deduction in federal taxable income and the revenue loss to the State. The Office of Tax Policy identified 221 corporations with a tax decrease of $3.6 million in this exercise. Extrapolations of these figures was one input into the fiscal note for decoupling from the FDII deduction.

[13] This includes the 5 or fewer corporations with a Maine address mentioned in footnote 8 above.

a return on extension.[14] Based on the filing patterns of large multinational corporations, tax year 2020 returns that have been processed to date may represent 50% or less of the total revenue increase from decoupling from the FDII deduction.

4. The annual revenue that would be generated by decoupling from the deduction

The fiscal note for P.L. 2021 included an increase in corporate income tax revenues from decoupling from the FDII deduction of $8.59 million in fiscal year 2021, followed by revenue increases of $10.5, $11.1 million, $12 million, and $12.5 million in fiscal years 2022 through 2025. At this point the MRS, Office of Tax Policy has not identified additional information that would necessitate updating those figures. The Office would, however, note the uncertainty of these estimates. This uncertainty is demonstrated by differences in the tax expenditure estimates by the Joint Committee on Taxation ("JCT") and the U.S. Treasury. JCT forecasted that the tax expenditure from the FDII deduction would increase from $17.5 billion in fiscal year 2021 to $37.4 billion in fiscal year 2024;[15] the U.S. Treasury estimated that the tax expenditure would increase from $6.8 billion in fiscal year 2021 to $13.7 billion in fiscal year 2024.[16] It should also be noted that potential federal legislative changes to the FDII deduction could result in a change to this estimate.

5. Whether there is some other deduction or incentive that would fulfill the purpose of the deduction in a more effective or efficient manner

The FDII deduction's place in the federal international taxation regime as one component to combat the shifting of profit and economic activity abroad is a uniquely federal purpose and, as such, the MRS, Office Tax Policy was unable to identify another State level deduction or incentive that would effectively address that purpose. However, the more general purpose of encouraging economic activity within the State is a familiar purpose that is more effectively and efficiently furthered by a number of State incentives. By way of example, these include the Educational Opportunity Tax Credit, the Research Expense Credit, the Seed Capital Tax Credit, the Pine Tree Development Zone program, and others.

Recommended legislation

In light of the above findings, the Department of Administrative and Financial Services does not recommend any legislation.

[14] Tax year 2020 corporate return data is also incomplete because of delays between return receipt and processing.

[15] Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024, JXX-23-20, November 5, 2020.

[16] Office of Tax Analysis, U.S. Treasury, FY 2023 Tax Expenditures, December 9, 2021. Available at https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2023.pdf.