State Responses to TCJA’s International Provisions

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Pre-TCJA Federal and State Taxation of Worldwide Income
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Pre-TCJA Federal Treatment - Generally

- U.S. Entities – taxed on worldwide income but income of foreign subsidiaries is not taxed until repatriated (typically through the payment of a dividend)
  - Special deductions
  - Subpart F income
  - Credit for foreign taxes paid
- Foreign Entities – taxed on U.S. source income determined under federal rules
  - Credit for foreign taxes paid
Pre-TCJA State Treatment – Generally

• States use formulary apportionment to source income
• Most states now require “combined” filing
• At one time, states sought to use worldwide combined filing and apportionment to source domestic and foreign income
  • U.S. trading partners urged the Reagan administration to have limits imposed on the states’ ability to do worldwide combined filing
  • States agreed to follow federal treatment of U.S. versus foreign source income – provided that the federal government committed to policing off-shore income shifting
• Combined filing states, therefore, apply some sort of “water’s edge” limitation on the combined group—but may include foreign dividends and subpart F income.
Other State Considerations

• The Foreign Commerce Clause of the U.S. Constitution and the dormant version of that clause
  • Generally:
    • Sufficient connection
    • No discrimination
    • Fair apportionment
    • No significant risk of multiple taxation
    • No interference with the ability of the federal government to “speak with one voice”
  • *Kraft Gen. Foods v. Iowa Dep’t of Revenue*
Federal Purpose in International Changes

- **Repatriation** –
  - The purpose is to shift from worldwide taxation of the income of domestic entities to more of a territorial style system.
  - Overseas earnings and profits that have not been repatriated would otherwise escape tax under this system.

- **Global Intangible Low Taxed Income (GILTI)** –
  - Attributes some portion of the income of foreign subsidiaries that would be foreign-sourced to the domestic parent and treats that income as U.S. income.
  - Taxes at a reduced rate and subject to a credit for foreign taxes paid.
Section 965
Repatriation
Repatriation Transition Tax: Determining the State and Local Impact

Overview of Issues
Impact of date of IRC conformity
Assuming the state conforms to the IRC post TCJA, is income included in federal income under IRC 965 included in the state tax base?

- Deemed repatriated foreign earnings are included in income under the Subpart F provisions, IRC 951(a), but are not technically defined as "Subpart F" income under IRC section 952
- Under this structure, such foreign earnings may not necessarily be excluded in states that do not tax subpart F income

• State tax policy reasons for inclusion/exclusion of 965 income
Repatriation Transition Tax: Determining the State and Local Impact

Overview of Issues (cont.)
Application of the IRC § 965(c) deduction (intended to lower the federal tax rate).
— IRC § 965(c) deduction is not a “special deduction” so should be allowed in most states that tax foreign earnings deemed retreated under IRC 965
— Interplay with applicable dividend-received deductions

Apportionment considerations
— Potential inclusion of 965 income
— Is there “factor relief” for the U.S. shareholder?
  - If there is no statutory factor relief, such relief may nevertheless be required by the U.S. Constitution?
  - How would factor relief work? Remember, the 965 inclusion is of deemed repatriated earnings from the past 30+ years.
Tax reform impact – GILTI

What are the state issues?
— Does the state conform to new section 951A?
— Is any GILTI included in the state tax base?
— If included in the state tax base, does GILTI receive receipts factor representation?
— How is GILTI sourced if included in the receipts factor? See a few approaches…..
— Is there any other means of excluding GILTI?
— Is there a foreign commerce clause argument that the income should be excluded or that factor relief is needed?
— How does the GILTI deduction work for state purposes?
— If there is an exclusion for GILTI, will the taxpayer still get the section 250 deduction?
— The same issue will present itself with the deduction being allowed under Code section 250 to reduce the tax rate on Foreign Derived Intangible Income (FDII)
State taxation of GILTI (as of 1/20/2019)

Does not tax GILTI

- No general corporate income tax

Tax GILTI at gross (do not allow 250)

- Subject to 85% exclusion
- Subject to 80% DRD
- Subject to 70% DRD

Tax GILTI at net (allow 250)

- Has not updated conformity; does not adopt 2018 changes, or has selective conformity and does not adopt
- Subject to 85% exclusion
- Subject to 80% DRD
- Subject to 70% DRD

Starting with 2019 tax years

- Unless recipient is domiciled in OK
- Subject to 85% exclusion
- Subject to 80% DRD
- Subject to 70% DRD

Not considering Foreign Commerce Clause and assuming 100 percent ownership

- CO foreign income subtraction may not result in 100% exclusion of GILTI

- NC: “net of related expenses”

- MA: Subject to 95% DRD

- CT: Subject to a 5% expense addback

- KY: Subject to expense addback

- Subject to 50% DRD
Section 163(j)
Issues to be addressed:

“Adjusted Taxable Income” for state purposes that is different from the federal?

Limitation applied at separate company level or combined group level (i.e., who is the “taxpayer”?)

What happens when combined group is different than consolidated group?

—Interplay of limitations for interest between related members in states with special in lieu of industry taxes such as insurance and telecommunications.

Is disallowed interest a tax asset of the group or a particular entity? How is it to be allocated among group members (e.g., if an entity leaves a group)?

How much interest is subject to state addback provisions where a taxpayer has both intercompany and third party interest expense subject to limitation?

What if the interest expense is treated as a non-business expense for state tax purposes?

How are federal carryovers amounts adjusted for separate state limitations?
2017 Federal Tax Act—Multistate Implications Interaction of IRC § 163(j) and State Intercompany Addback Rules

Is interest limited under IRC § 163(j)?
• IRC § 163(j) limitation calculation
• Proper calculation level

Is any deductible interest paid to a related party in a state with an addback requirement?
• Amount of post limitation deduction that is intercompany vs 3rd party

Does a full addback exception apply?
• If applicable, was the interest "paid in the taxable year"?

Deduct Partially Allowed Interest or No Interest

Deduct Federal Interest
Thank you