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State Taxation of Foreign Income – An Update on State TCJA Conformity, Subpart F Inclusion, Factor Representation, and other issues

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9:45-10:45am

State Taxation of Foreign Income

Update on State TCJA Conformity, Subpart F Inclusion, Factor Representation, and other issues

Moderator

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Agenda

- Past
  - How have states historically taxed foreign income and why
- Present
  - Current issues and trends
- Future
  - Where is this all headed?

Past

How have states historically taxed foreign income and why

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Tax R

State Taxation of Foreign Income

Federal conformity:

- States differ on how they conform to the IRC
- State conformity dates are key:
  - “Fixed” (or “static”) conformity states = conformity **generally** automatic (consider whether and when to conform)
  - “Rolling” conformity states = conformity **generally** automatic (consider whether to decouple)
  - “Selective” conformity states = conformity **generally** depends (consider whether and when to conform)
    - “Selective” states **generally** adopt only certain specific provisions of the IRC, typically (but not always) as of a specific fixed date.

State Taxation of Foreign Income

- Tax Base
  - Subpart F income generally not taxed
    - Iowa taxpayers may deduct the portion of Subpart F income that would be deducted under IRC §243
    - Massachusetts treats Subpart F income as a dividend eligible for the state's DRD
  - Foreign dividends treated the same as domestic dividends
    - Combined returns have added complexity
- Apportionment
  - Foreign factors generally included if income included in the tax base
    - *Oracle Corporation and Subsidiaries v. Oregon Department of Revenue*
- Filing Methodology
  - Worldwide reporting allowed but not required
  - Water's-edge returns can include foreign income and factors

Key Court Cases

Kraft General Foods, Inc. v. Iowa Department of Revenue **505 US 71 (1992**

- Iowa's taxation of dividends from foreign subsidiaries, but not domestic subsidiaries, was unconstitutional

Appeal of Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993)

- Denied taxpayer challenge that taxation of foreign dividends was a facial violation of the Foreign Commerce Clause.

Present

Current issues and trends

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Current Issues and Trends

Repatriation Transition Tax:

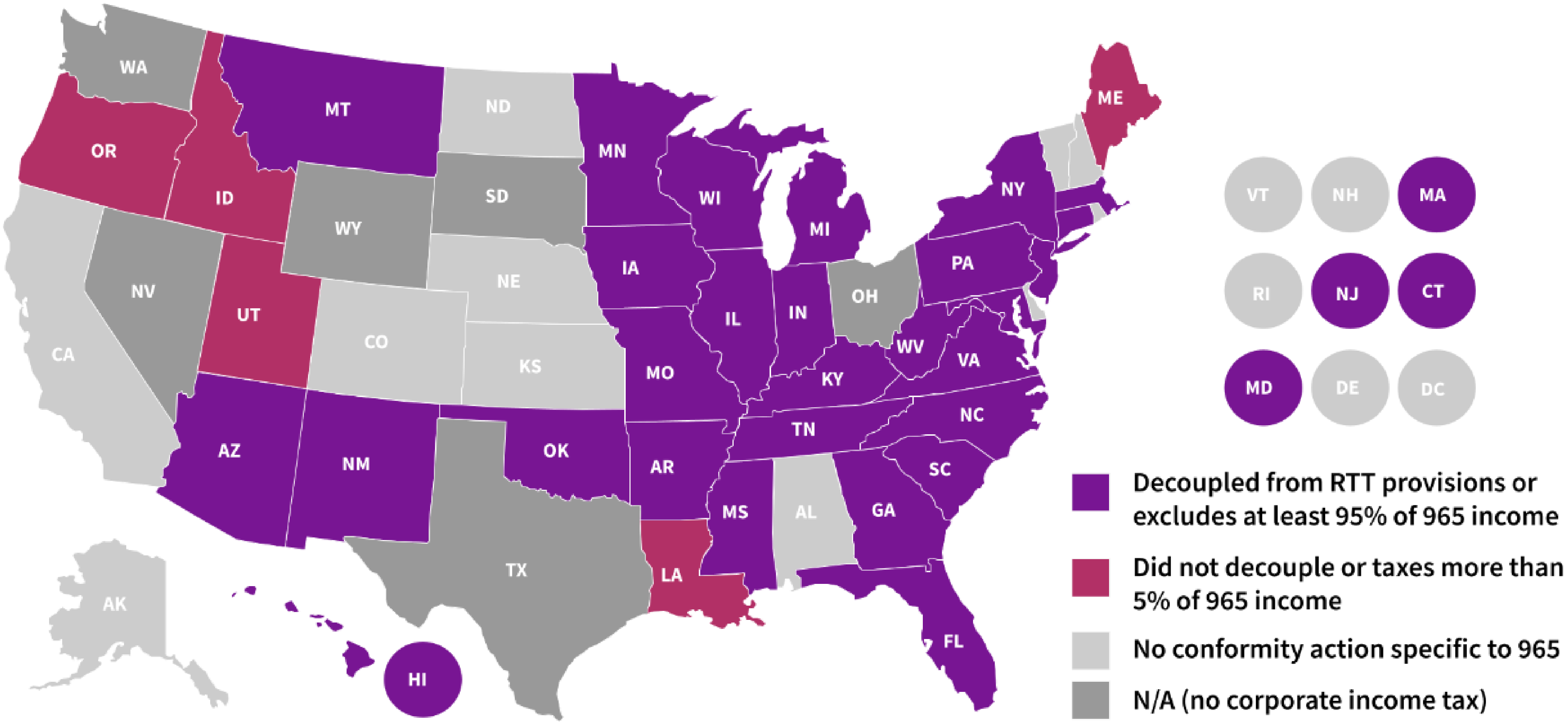
- Accumulated foreign earnings held by CFCs of a US shareholder will be deemed repatriated and taxed federally at a rate of 15.5% if attributable to cash or cash equivalents and at a rate of 8% if attributable to illiquid assets.
    - Mechanically, consists of an addition under 951(a) and a deduction under 965(c).
- The taxpayer may then elect to pay the resulting federal income tax liability over an eight-year period.
- State tax impact:
    - The RTT Addition included in federal taxable income under 951(a) should automatically result in an increase to that state tax base in rolling conformity states unless the state has a specific exclusion for such income (e.g., exclusion for CFC income).
    - The RTT Deduction may or may not be allowed for state purposes depending on how state defines its base (i.e., taxable income or by reference to Line 28).
    - Deferral: Likely not applicable for state purposes, unless specifically allowed.

Current Issues and Trends

- Repatriation of foreign earnings (cont.)
  - Treatment of PTEP
  - Differences between state and federal DRD provisions
    - Complications created by acquisitions, changes in filing methods, etc.
- State treatment of IRC 367(d)
  - Conformity and Consequences
  - Illinois Dept. of Rev. General Information Letter IT 22-0002-GIL, 01/11/2022

CURRENT ISSUES AND TRENDS

Which states decoupled from the TCJA's **Repatriation Transition Tax** provisions?



Nebraska's Department of Revenue has issued guidance providing that 965 income is taxed, but such guidance is inconsistent with Nebraska's statute. The **New Mexico** Department of Revenue issued guidance providing that 965 Income is excluded only for separate company filers.

Source: McDermott Will & Emery LLP

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Current Issues and Trends

Global Intangible Low-Taxed Income (GILTI)

- Tax on a US shareholder's share of its CFCs' global intangible low-taxed income at a reduced effective rate of 10.5 percent (13.125 percent beginning in 2026). Intended to tax portion of CFC's active income equal to the excess of an imputed 10 percent rate of return on the CFC's adjusted bases in tangible depreciable property used to generate the active income.
- Like RTT, mechanically consists of addition (new IRC 951A) and smaller deduction (new IRC 250).
- State tax impact:
  - GILTI Addition: Likely included in base absent statutory exclusion.
  - GILTI Deduction: Special deduction under IRC 250, so inclusion in base depends on whether before or after special deductions.
  - For both RTT and GILTI, must consider characterization (business/nonbusiness) and apportionment (factor representation).

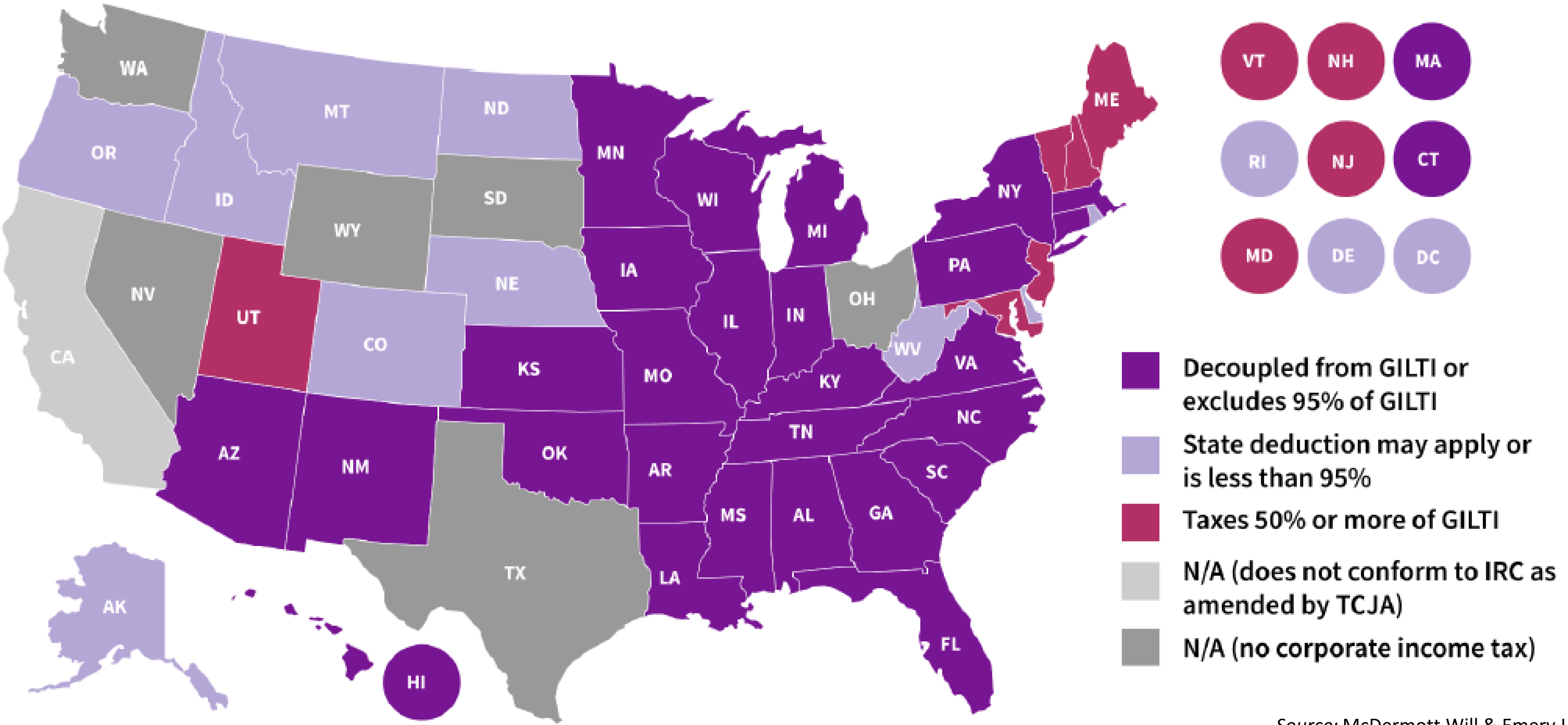
Current Issues and Trends

Foreign-Derived Intangible Income (FDII):

- Unlike GILTI, FDII is not a bucket of income, but instead, a preferential rate for above-routine income arising from foreign markets.
- Eligible corporations will pay an effective rate of 13.125% on this income.
- The effective rate is achieved through a deduction in IRC 250.
- This deduction is only available to C corporations.
- Deduction under IRC 250 will be permitted in the state tax base?

CURRENT ISSUES AND TRENDS

Which states decoupled from the TCJA's **Global Intangible Low-Taxed Income (GILTI)** provisions?



Source: McDermott Will & Emery LLP

Current Issues and Trends

Recent legislative wins

- After a three-year effort, the Kansas legislature enacted a law decoupling from GILTI and the 163(j) limitation and clarifying that the 80% DRD applies to 965 Income.
- Alabama recently decoupled from GILTI and enacted legislation providing that the 163(j) limitation does not apply if there is no federal limitation.

- Decoupling efforts are still happening in states that tax GILTI and states that conform to the 163(j) limitation.

Current Issues and Trends

- Factor inclusion and representation
    - *Kraft* considerations
    - Possible approaches
        - Augusta Method
        - Detroit Method
        - Net inclusion
    - Rough justice
        - Net inclusion v. none
        - E.g., NY v. TN and MA
    - No clear consensus on the measure for distortion arising from foreign income

Current Issues and Trends

- In the Matter of the Protest of Apache Corporation & Subsidiaries to assessment issued under Letter Id No. L1272612144 V. New Mexico Taxation and Revenue Department, 21-21, 08/24/2021
    - Foreign income, including Subpart F
    - Business v. non-business
    - Rough justice apportionment – 30% exclusion
- State of Alaska, Dep't of Revenue, Appellant and Cross-Appellee, v. Nabors International Finance Inc. & Subsidiaries, Appellee and Cross-Appellant., 514 P3d 893, 08/05/2022
    - Combined reporting of subsidiaries in tax havens
    - Discrimination against foreign commerce
- Colo. Rev. Stat. 39-22-303(8)(b)
    - Colorado Department of Revenue, Income Tax Topics: Section 303(8)(b) Entities

Future

Where is this all headed?

Convergence of State and International

International		**State**
Revenue threshold	Nexus	Factor presence
"End market jurisdiction"	Sourcing	Market sourcing
BEAT, GloBE	Intercompany Transactions	Intercompany Expense Disallowance

Does convergence create opportunities for data and process efficiencies?

Convergence of State and International

Preparing for the Future

- Legislative advocacy
  - Industry groups and coalitions immediately started advocating for favorable responses to TCJA and it worked! The majority of states do not tax a material portion of 965 Income or GILTI.
- Seeking guidance from state tax departments
  - The STARR Partnership requested guidance from the Missouri Department of Revenue and received favorable guidance (965 Income and GILTI both excluded from the tax base)
- Consider positions on original vs. amended returns
- Documentation for potential state at audit

Tension Between State and International

- Application of tax treaties
  - E.g. New York
- Sourcing mechanisms
- Residence v. source-based taxation
- Different treatment of larger businesses
- Use of financial accounting principles for tax calculations
  - Book Minimum Tax—Alaska v. the lower 48
- Treatment of “above routine” profits

Q&A

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