State Taxation of Foreign Income: The Expanding Water’s Edge
Agenda

• Overview
• Inbound Issues
  ▪ Nexus
  ▪ Federal Conformity
• Outbound Issues
  ▪ Composition of the Combined Reporting: *Worldwide v. Water’s Edge*
    ▪ State Treatment of CFC/Subpart F Income
  ▪ Tax Haven Legislation
  ▪ Dividends from Domestic and Foreign Subsidiaries
  ▪ Other Apportionment Issues
• Transfer Pricing – MTC Initiative
• State Responses to Corporate Inversions
Overview

• The traditional distinction between inbound and outbound international tax concepts becomes somewhat blurred when discussing overlap with state tax concepts

• Traditional “outbound” issues
  ▪ Foreign tax credits (FTC)
  ▪ CFC income
  ▪ PFICs

• Traditional “inbound” issues
  ▪ Branch profits tax
  ▪ Earnings stripping/interest deduction limits

• State tax issues often have both an “inbound” and “outbound” perspective
  ▪ Composition of combined group
  ▪ P.L. 86-272 (Inbound – Nexus) (Outbound – Apportionment/Throwback)

• Accordingly, presentation will offer viewpoints of many topics from both inbound and outbound perspectives
Overview

Jurisdiction to Tax

Sales/Use Tax
- Physical Presence
- Attributional Presence

Income Tax
- Physical Presence / Attributional Presence
- Physical Presence / Economic Presence
- Combined Reporting
  - W/E or W/W
  - Tax Haven Inclusion
  - 80/20 Companies
- Separate Reporting
- Tax Base Computation
  - Federal Starting Point or Recomputation
  - Expense Disallowance
  - Apportionment Factor Representation
Overview

- Treaties don’t cover state and local taxes
  - Income tax treaties are expressly applicable only to federal income taxes and do not apply to subnational, state taxes – income or otherwise
  - Foreign corporate taxpayers often are surprised to learn they are subject to state income taxes even though they are not subject to federal income taxes
- *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979)
Overview

• Constitutional Framework: Commerce Clause
  - The Commerce Clause, Article I, Section 8, Paragraph 3 of the U.S. Constitution, provides that:
    “The Congress shall have power to regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes”.
  - After Complete Auto Transit v. Brady (1976), a state tax upon interstate commerce must:
    [1] Be applied to an activity with a substantial nexus with the taxing State,
    [2] Be fairly apportioned,
    [3] Not discriminate against interstate commerce, and
    [4] Be fairly related to the services provided by the State.

• The Foreign Commerce Clause adds two additional requirements:
  [5] Tax cannot create unconstitutional risk of international double taxation,
Overview

• U.S. state tax regime does not employ a source-based methodology but relies on formulary apportionment to divide the taxable income of a unitary business among the states in which it conducts business. States use a variety of apportionment formulas:
  - General three-factor formula using property, payroll, and sales factors
  - Weighted sales factor formulas
  - Proliferation of single sales factor apportionment
    - Along with market-based sourcing
• Unitary business principle (“flow of value”)
  - Functional integration
  - Centralization of management
  - Economies of scale
• *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983)
  - Court concluded that overseas subsidiaries may be included in a unitary business for formulary apportionment
• *See also Barclays Bank PLC v. Franchise Tax Board; Colgate-Palmolive Co. v. Franchise Tax Board*, 512 U.S. 298 (1994)
INBOUND ISSUES
NEXUS
Nexus

• If a foreign corporation has state nexus but does not have federal taxable income by reason of treaty protection or lack of ECI, will it be subject to state income tax?
  ▪ **No**: Tennessee, South Carolina, Massachusetts and states that piggyback federal taxable income
  ▪ **Yes**: New York, California, Michigan, Pennsylvania and states with add-backs
  ▪ **Maybe**: Many states have no clear authority

• Consequences of state nexus is that a corporation is subject to state tax on an apportioned basis, without credits or assignment of income to a particular location
Nexus

• Foreign Corporations and Public Law 86-272
  ▪ Public Law 86-272 applies to “interstate” commerce
    ▪ Several states have announced that they will apply Public Law 86-272 to transactions in foreign commerce (e.g., Alabama, Illinois, Kentucky, Michigan)
    ▪ Some states specifically do not apply PL 86-272 protection to foreign commerce
    ▪ California: applies only to U.S. states and Puerto Rico
  ▪ MTC guidelines apply only to U.S. commerce, but provides language for a state to use if it wants to apply it to foreign commerce
    ▪ States that adopted the MTC guidelines without revision (i.e., do not specifically exempt foreign commerce) include: Arkansas, Colorado, Hawaii, Idaho, Louisiana, Montana, New Jersey, New Mexico, North Dakota

• Exclusion of foreign corporations from P.L. 86-272 protection unconstitutional?
  ▪ Treats similarly situated domestic and foreign companies differently
  ▪ Could violate international trade rules or provisions of U.S. tax treaties
Nexus

• Business activity taxes
• Economic nexus vs. physical presence
  ▪ “It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there.” Geoffrey, Inc. v. S.C. Tax Comm’n, 437 S.E.2d 13, 18 (S.C. 1993), cert. denied, 510 U.S. 992 (1993)
• “Alternative” tax regimes
  ▪ Ohio commercial activity tax
  ▪ Texas Franchise (margin) tax
  ▪ Washington business and occupation tax
  ▪ But compare federal tax thresholds (ETB, ECI, PE) with modern economic nexus statutes:
    ▪ MTC Factor Presence test ($500k in sales)
    ▪ Cal. Rev. & Tax Code § 23101 ($500k in sales)
    ▪ See also MI ($350k in sales); OH ($500k in sales); WA ($250k in sales)
Nexus

- Increasing international focus on “nexus”
- BEPS Action 5 – Harmful Tax Practices
  - Proposes to apply a “modified nexus” approach for purposes of determining whether tax incentive regimes are “harmful tax practice
  - Focus is on cost as the sole factor for purposes of determining amount of income eligible for beneficial regime.

\[
\text{Qualifying IP Expenditures} \times \frac{\text{Overall IP Income}}{\text{Total IP Expenditures}} = \text{Eligible IP Income}
\]
FEDERAL CONFORMITY
Federal Conformity

• State tax base – conformity to federal taxable income:
  ▪ States generally are not limited by U.S. treaties.
  ▪ Many states conform “mechanically” to the I.R.C.
  ▪ Several states have specific provisions for conformity to federal taxable income and treatment of foreign source income.
  ▪ Some states base tax on federal income as if the excluded non-U.S. income was subject to federal tax.
  ▪ Some states require taxpayers to “add back” federal deductions for payments of royalties, interests and other costs and expenses to foreign affiliates.
Federal Conformity

• Examples of non-conformity:
  ▪ **Pennsylvania** requires a corporation that is not subject to federal tax due to a treaty to report income that would have been reported if the income had not been exempted.
  ▪ **New York** requires all corporate taxpayers to include all income from sources outside of the U.S. that was not included in computing federal taxable income. *See Reuters Limited v. Tax Appeals Tribunal, 82 N.Y.2d 112 (N.Y. S. Ct. 1993); Matter of Infosys Technologies Ltd., DTA No. 820669 (N.Y. Tax App. Trib. Feb. 21, 2008).*
  ▪ **New Jersey** regulations also require inclusion of all income from sources outside of the U.S. that was not included in computing federal taxable income, but this regulation was declared invalid in *IBM v. Director, Division of Taxation, 26 NJ Tax 102 (2011).*
  ▪ **California** will only exclude income exempted by treaty under federal law if the treaty specifically applies to state income taxes (generally, U.S. tax treaties do not). Cal. Franchise Tax Bd., Supplemental Guidelines to California Adjustments, FTB Pub. 1001.
  ▪ **Oregon** will not exempt a foreign corporation exempt from federal income tax via U.S. treaty unless the treaty contains a provision exempting the foreign corporation from state taxes “upon or measured by net income.” Or. Admin. R. 150-317.010(10)-(B).

• States have discretionary authority to adjust items of income.
Federal Conformity

  - Alaska adopts by reference “Sections 26 U.S.C. 1-1399 and 6001 – 7872 (Internal Revenue Code)…unless excepted to or modified by other provisions of this chapter
    - Background – *Alaska Dep’t of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399 (Alaska 1998)
  - Schlumberger is a domestic corporation doing business in Alaska and filed a water’s-edge combined return
    - Combined return included a foreign holding corporation that managed and received substantial dividends from the group’s foreign subsidiaries
  - Under federal law, dividends received by FHC from foreign subs not ECI and not subject to federal tax
  - Alaska’s water’s-edge reporting methodology had the effect of including 20% of foreign dividends paid to FHC in a combined report, subjecting it to apportionment
  - Court held that Alaska’s apportionment methodology was “simply inconsistent” with federal sourcing rules and thereby modified the otherwise adopted federal treatment to tax the dividends
OUTBOUND ISSUES
COMBINED REPORTING: WORLDWIDE V. WATER’S EDGE
Combined Reporting

- **Worldwide combined reporting**
  - Held constitutional in *Container* and *Barclays Bank*, but no state generally requires worldwide combined reporting without providing water’s edge election.

- **Water’s-edge reporting**
  - May be elected in several states—e.g., California, Idaho, Utah, Massachusetts
  - Required in many states—e.g., Illinois, Wisconsin, Michigan, Minnesota
  - Generally excludes affiliates with 20% or less activity in U.S.
  - May be measured by sales or combination of factors
  - Includes (in CA) certain Subpart F income of non-U.S. members
  - Some states include non-U.S. members that earn more than 20% of income from intangible property or services-related activities that are deductible by other members, to extent of income and apportionment factors
  - Other states exclude foreign and U.S. companies if 80% or more of the business activity is outside of the U.S.
  - Includes (in some states) entire income of member doing business in a tax haven

- **Filing methods - 80/20 companies**
  - Measured by payroll, property, and/or sales
Combined Reporting - Water’s Edge Election

• Rules vary by state, but generally excludes foreign affiliates from combined report
  ▪ Which foreign entities are included/excluded
  ▪ Whether foreign entity should include only U.S. source income
  ▪ Whether 80/20 rule should include domestic entities
  ▪ Effect on intercompany transactions between domestic and foreign affiliates

• California
  ▪ Income and apportionment factors of unitary CFCs are included
  ▪ Subpart F income over earnings and profits
  ▪ Issues regarding extent to which Subpart F regime has been adopted (*Fujitsu v. Franchise Tax Board*)
Tax Havens

• Tax haven laws
  ▪ Several states have adopted “tax haven” laws, which require a taxpayer to include a foreign affiliate in its state group return, even if the taxpayer has made a water’s edge election.
  ▪ These laws require taxpayers that have made a water’s edge election to include the income and/or factors of a foreign affiliate, if the foreign affiliate was formed or has significant business activity in a “tax haven.”
Tax Havens

• Tax haven laws

  ▪ The following states have enacted tax haven laws:
    ▪ Alaska
    ▪ District of Columbia
    ▪ Montana
    ▪ Oregon
    ▪ Rhode Island
    ▪ West Virginia
  ▪ Maine considered and rejected tax haven legislation this year
  ▪ These states identify a “tax haven” using one of the following methods:
    1. “Black list” of tax haven jurisdictions
    2. Statutory multipronged test
Tax Havens

1. “Black list” of tax haven jurisdictions

- States have enacted a statutory “black list” of jurisdictions that are designated by the state legislatures as “tax havens.”
- Oregon has published a list of 39 jurisdictions.
  - An Oregon consolidated return must include the taxable income or loss of any affiliate that is a member of the taxpayer’s unitary group and is incorporated in any of the identified “tax havens” regardless of its business activities.
- Montana has published a list of 43 jurisdictions.
  - The Department is required to provide the State Legislature with an updated black list every two years.
2. Statutory multipronged test

- Several states employ statutory multipronged tests to determine if a jurisdiction is a “tax haven.”
  - D.C. defines a “tax haven” as a jurisdiction that meets ANY of the following:
    1. Has no or nominal effective tax on income and has laws or practices that prevent the effective exchange of information for tax purposes with other governments;
    2. Lacks transparency;
    3. Permits the establishment of foreign-owned entities without requiring a local substantive presence or prohibiting these entities from having commercial impact on the local economy;
    4. Explicitly or implicitly excludes the jurisdiction’s resident taxpayers from taking advantage of the tax regime’s benefits; OR
    5. A jurisdiction that has created a tax regime that is favorable for tax avoidance.
- Rhode Island and West Virginia define a “tax haven” using similarly worded five-factor tests.
- Alaska has adopted a different statutory definition for a “tax haven.”
Tax Havens

• Unitary Group Composition: Tax Havens

  ▪ Oregon is the most recent state to amend its definition of unitary group to include foreign subsidiaries located in “tax haven” jurisdictions, joining Alaska, DC, Montana and West Virginia.

  ▪ Effective for tax years beginning on or after January 1, 2014, Or. Rev. Stat. § 317.715(2) is amended to include tax haven corporations in the unitary group, if located in the following countries:

    ▪ Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, the Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, the Isle of Man, Jersey, Liberia, Liechtenstein, Luxembourg, Malta, the Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, the Netherlands Antilles, Niue, Samoa, San Marino, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, the Turks and Caicos Islands, the U.S. Virgin Islands and Vanuatu.
Tax Havens

• Unitary Group Composition: Tax Havens
  ▪ Foreign countries labeled “tax havens” by state legislatures are cognizant of the resulting SALT implications for their affected foreign subsidiaries.
  ▪ For example, numerous foreign embassies sent letters in opposition to tax haven legislation recently considered in Montana and California:
    ▪ Singapore, Great Britain, Switzerland, Luxembourg

• Example:
  ▪ Letter from Embassy of Switzerland to then-Governor Schwarzenegger and Members of the California State Legislature, April 9, 2010 (in opposition to AB 1178).
    ▪ “In general, I do not believe that blacklisting particular jurisdictions and penalizing companies affiliated with them is an effective means of ensuring tax compliance.”
DIVIDENDS FROM DOMESTIC AND FOREIGN SUBSIDIARIES
Foreign Dividends

• Taxation of inbound dividends paid to U.S. taxpayers
  ▪ Treatment of dividends from foreign subsidiaries
  ▪ Many states allow a dividends received deduction (DRD) based on federal DRD
    ▪ 100% deduction for 80% or more owned U.S. subsidiaries
    ▪ 80% deduction for 20%-80% owned subsidiaries
    ▪ 70% for other domestic subsidiaries
    ▪ Dividends from foreign subsidiaries may qualify for the DRD if the income of the foreign subsidiary had been subject to U.S. tax as ECI
Foreign Dividends

• Foreign dividends
  ▪ In light of the *Kraft* (Iowa) decision, most states allow a subtraction modification for foreign dividends that matches the DRD for dividends for domestic companies
  ▪ Many allow a 100% subtraction for foreign dividends
  ▪ Some states that do not follow the federal DRD rules also do not permit a subtraction of foreign dividends. *Morton Thiokol* (Kansas 1993); *General Electric* (NH 2006)
Domestic 80/20 Companies Included in Water’s Edge Group: California

- California Revenue and Taxation Code Sect. 25110 allows a water’s edge election, whereby any member of the unitary group which is incorporated outside the U.S. and which has a U.S. apportionment factor (as measured by property, payroll and sales within and without the U.S.) of less than 20% is excluded from the combined report.

- Domestic 80/20 companies included per Sect. 25110(a)(3)
Inbound dividends

- From domestic 80/20 company: 100% dividends-received deduction per CRTC Sect. 25106, as 80/20 company is included in water’s edge return.
- From foreign 80/20 company: 75% dividends-received deduction per CRTC Sect. 24111, if entire income of 80/20 company is excluded from water’s edge return.
- From foreign 80/20 company, some portion of whose income and apportionment factor is included in water’s edge return: Per Apple, Inc. v. Franchise Tax Board, the portion of the dividend related to income included in the water’s edge return is subject to a 100% dividends-received deduction, with the remainder subject to the 75% deduction per CRTC Sect. 244. The dividends income is subject to the last-in-first-out ordering rule.
Domestic 80/20 Companies Excluded from Water’s Edge Group: Illinois

- Illinois Compiled Statutes, Sect. 35 ILCS 5/1501(a)(27) excludes from the definition of a “unitary business group” any member whose business activity outside of the U.S. is 80% or more of such member’s total business activity as measured by the standard payroll and property factors prescribed.
OTHER APPORTIONMENT ISSUES
Apportionment

• Outbound apportionment factors
  ▪ Application of Public Law 86-272 standard for throwback of sales to foreign countries ("taxable in the other state")
    ▪ *Dresser Industries* (CA SBE 1982)
    ▪ *Morton International* (IL 2004)
    ▪ Indiana Letter of Finding No. 02-20120352 (March 1, 2013)
  ▪ States contend that mere solicitation in a foreign country is not enough and that activity satisfying Public Law 86-272 activity must be demonstrated to avoid throwback
Apportionment

- Factor relief for foreign dividends, royalties and interest from foreign subsidiaries
  - In general, taxpayers have been denied factor relief
    - New Mexico: *NCR Corp.*, 856 P.2d 982 (N.M.1993), cert. denied (1994); *Conoco Inc.*, 931 P.2d 730 (N.M. 1996)
    - Minnesota: *NCR Corp.*, 438 N.W. 2d 86 (Minn. 1989)
  - However, the Maine Supreme Court granted factor relief for foreign dividends in *Tambrands, Inc.*, 595 A.2d 1039 (Maine 1991)
  - Maine subsequently changed its law to include dividends from foreign subsidiaries without factor relief as long as the resulting taxable income did not exceed taxable income calculated using worldwide apportionment (the “Augusta Formula”). The Augusta Formula was upheld as constitutional in *E.I. DuPont de Nemours*, 675 A. 2d 82 (Maine 1996)
TRANSFER PRICING – MTC INITIATIVE
The Use of State Section 482 Provisions as Tool for Expense Disallowance

- Many states have enacted statutory provisions similar to IRC 482. See e.g.:
  - Ala. Code § 40-2A-17
  - Fla. Stat. § 220.44
  - Ga. Code Ann. § 48-7-58
  - Tenn. Code Ann. 67-4-2014
The Use of State Section 482 Provisions as Tool for Expense Disallowance

• Litigation
  ▪ Pending and settled cases in Louisiana and Utah
    ▪ State does not argue that taxpayer’s intercompany transactions are not at arm’s length – no arm’s length analysis conducted
      ▪ State cannot afford to engage in full transfer pricing evaluation
    ▪ State essentially argues intercompany pricing, by definition, cannot be at arm’s length and must be disregarded under its 482 statute
    ▪ Deduction of intercompany expense must be disregarded in order to prevent evasion of taxes
MTC Transfer Pricing Initiative

• Arm’s-Length Adjustment Service (ALAS) Advisory Group tasked with devising how, and to what extent, the MTC can incorporate transfer pricing services to member states
  ▪ Identified the lack of economic expertise as primary roadblock to addressing transfer pricing issues
• In October, the Group met with seven outside firms
• Third-Party firms may assist with audit selection, State Department training, and economic analysis
  ▪ Firms may support their economic analysis at the audit, negotiation, and litigation levels
  ▪ ALAS predicts the project will conservatively recoup $25 million annually
OECD Transfer Pricing Initiative

- Much of the OECD’s BEPS discussions are focused on transfer pricing
  - Increasing information available to tax authorities with respect to cross border transactions
- Wither the arm’s length standard?
  - Continuing discussion around whether the arm’s length standard is appropriate in all cases and whether a formulary apportionment method might produce more predictable results that help combat base erosion and profit shifting.
STATE RESPONSES TO CORPORATE INVERSIONS
State Tax Responses

- State tax issues associated with inversions relate in most respects to the “piggyback” relationship between state corporate income tax and federal corporate income tax
  - Nearly every state conforms to the Internal Revenue Code to determine corporate income
- States have considered the following anti-inversion strategies:
  - Worldwide combined reporting
  - “Tax haven” laws
  - Legislation denying state tax and financial benefits
State Tax Responses

- **Worldwide combined reporting**
  - Worldwide combined reporting requires a taxpayer to include a foreign affiliate in its state group return if the foreign affiliate is part of the taxpayer’s unitary group.
  - Worldwide combined reporting eliminates the tax advantages of an inversion by including the income and factors of the foreign affiliate in the state return, even if the foreign affiliate is excluded from the U.S. tax base.
  - Currently, all states with worldwide combined reporting regimes allow taxpayers to make a water’s edge election, which permits a taxpayer to exclude all of its foreign affiliates from the state group return.
    - **Exception: Oil companies in Alaska**
State Tax Responses

• Tax haven laws

  Several states have adopted “tax haven” laws, which require a taxpayer to include a foreign affiliate in its state group return, even if the taxpayer has made a water’s edge election.

  These laws require taxpayers that have made a water’s edge election to include the income and/or factors of a foreign affiliate, if the foreign affiliate was formed or has significant business activity in a “tax haven.”
State Tax Responses

• Legislation denying state tax and financial benefits
  
  New Jersey – State Senator Shirley Turner (D-Mercer, Hunterdon) has proposed the following legislation, which would deny state benefits to companies that have taken part in corporate inversions:
  
  - SB 2397 would prohibit corporations from qualifying for or maintaining state development subsidy grants if the corporation qualifies as an inverted domestic corporation.
  - SB 2398 would prohibit New Jersey’s pension fund from investing in companies that have been involved in a corporate inversion.
  - SB 2361 would prohibit some domestic corporations that reorganize overseas from being awarded state contracts. It would also require that the state treasurer be responsible for determining on behalf of the state or any independent state authority whether a corporation seeking a contract or subcontract is an inverted domestic corporation, according to the bill.
  
  These bills are currently in Committee.
State Tax Responses

• Legislation denying state tax and financial benefits
  - **Michigan** – HB 5920 would deny the awarding of benefits for “all loan, grant, incentive, or economic assistance programs” to any business entity that has undergone a tax inversion within 10 years prior to the date of the application for assistance.
  - The measure defines the term “tax inversion” as the relocation of a business entity’s corporate headquarters to a lower-tax country while its material operations are maintained in the United States, as determined by the Michigan treasurer.
  - HB 5920 died in Committee.
Questions?

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