

State Corporate Income Tax Obstacles & Potential Opportunities in Domestic and International Reorganizations and Transactions

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Agenda

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Jurisdiction

Foreign Commerce Clause and Jurisdiction

- Treaty provisions generally do not apply to the states (unless the states voluntarily apply them)
- Four requirements of *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977):
 - Substantial Nexus
 - Fairly apportioned
 - Not discriminate against interstate commerce
 - Fairly related to services provided by the state
- Plus two additional requirements from *Japan Lines, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1981):
 - States cannot create a substantial risk of international multiple taxation
 - States cannot prevent federal government from speaking with one voice with regard to international relations

Foreign Commerce Clause and Jurisdiction

- States have jurisdiction to impose on corporations meeting substantial nexus standards an apportioned income tax that does not discriminate against foreign commerce
- States generally do not conform with federal “permanent establishment” rules
 - Employees or property in state generally creates nexus
 - Economic nexus
 - Factor presence nexus

Foreign Commerce Clause and Jurisdiction

Does P.L. 86-272 apply to foreign commerce?

- Most states appear to apply P.L. 86-272 to foreign corporations
- California says: “No.” *Dresser Industries, Inc.*, SBE, 82-SBE-307, June 29, 1982, *reh’g* denied, October 26, 1983. CA Reg. § 25122(c)

Issues may arise if:

- Foreign company uses company vehicles and personnel to deliver goods
 - Particularly if they pick up returned/damaged goods
- Foreign company conducts non-solicitation activities in the state (even if through third-parties), such as
 - Training on use of products
 - Repair services
 - Investigating credit
 - Repossessing goods
 - Collecting accounts

Foreign Commerce Clause and Jurisdiction



- Foreign manufacturer sells goods to a company headquartered in NY
- Goods shipped via common carrier to U.S. Company's distribution centers throughout the United States
- Foreign manufacturer has no physical presence or solicitation activities in the U.S.
- Foreign manufacturer has no effectively connected income

Does Foreign Manufacturer have nexus with any state?

Tax Base

Tax Base

Many states start with federal taxable income as the starting point for computing state taxable income.

- Federal taxable income takes into account the concepts of ECI and PE where a treaty applies
- Without a modification, foreign corporations with no federal taxable income reported on Form 1120F arguably have no state taxable income (but may have minimum tax obligations)
- Some states use ECI as a starting point, but don't respect treaty exemptions
- Without modification, income reported on Form 1120F is generally limited to income earned in the U.S., not worldwide income
- Some states explicitly require worldwide income computations without regard to limitations on taxable income under the IRC or treaties (no longer in New York and New Jersey)

Tax Base - Dividends

Kraft General Foods, Inc. v. Iowa, 505 U.S. 71 (1992)

- The U.S. Supreme Court reversed the Iowa Supreme Court and held that the Iowa tax facially discriminated against foreign commerce. “Blind conformity” was held to be unconstitutional.

In the Matter of the Appeal of Morton Thiokol, Inc., 254 Kan. App. 2d 23 (1993)

- The Kansas Supreme Court, relying on a suggestion appearing in footnote 23 of the *Kraft opinion*, upheld the taxation of the foreign dividends finding that there was no discrimination
- The entire income of the domestic subsidiaries and the dividends from foreign subsidiaries were included in the income subject to apportionment to Kansas. Because both were included in the tax base, the court concluded that there was no discrimination.

Courts in some other combined return states have followed *Morton Thiokol*:

- New Hampshire - *General Electric Company v. Department of Revenue*, 154 N.H. 457 (2006)
- Maine - *E.I. Du Pont de Nemours & Co. v. State Assessor*, 675 A. 2d 82 (1996)
- Despite the *Morton Thiokol* authority, many combined reporting states provide a 100% DRD for dividends received from controlled foreign corporations

Tax Base - Subpart F

- Generally, IRC § 1248 provides that if a taxpayer owns 10% or more of the stock of a CFC and such stock is sold, then gain attributable to the sale is treated as a dividend from the foreign corporation to the extent of the stockholder's share of the corporation's E&P
 - IRC § 1248 has the effect of converting capital gain to dividend income potentially eligible for any state DRD.
 - Most states do not modify the treatment of gains from the sale of a foreign corporation's stock mandated by § 1248.
- Some exceptions:
 - California – does not incorporate IRC Sec. 1248. Cal. Rev. & Tax. Code § 24990.7.
 - Alaska – DRD does not apply to “gain treated as a dividend for federal tax purposes under Internal Revenue Code section 1248.” Alaska Admin. Code tit. 15 § 20.100(h).

Tax Base - Subpart F

- Under Subpart F, certain taxpayers are taxed directly on income earned by certain controlled foreign corporations
 - States generally include Subpart F income in the state tax base unless a specific exemption applies
 - Some states provide a specific deduction for Subpart F income or include Subpart F income as a dividend eligible for a dividends received deduction;
- California water's-edge filers include a portion of CFC's income in water's edge return
 - The CFC's net income is multiplied by a ratio of its subpart F income for the taxable year to its earnings and profits ("E&P") for the taxable year to arrive at the amount of CFC income that will be included in the combined report.

Tax Base - Section 78 Gross Up

- Generally, IRC § 78 provides that if a taxpayer owns 10% or more of a foreign corporation and is claiming foreign tax credits, then any dividend from that foreign corporation is grossed up for the foreign taxes deemed paid by the corporation (See IRC §§ 902 and 960)
 - Because states do not allow the use of the foreign tax credits, most allow the § 78 gross-up portion of the dividend to be subtracted from federal taxable income
 - MA allows only 95% to be deducted from federal taxable income

Tax Base - Expense Disallowance

- Some states may disallow expenses associated with Subpart F income or foreign dividends
 - The subtraction for Subpart F income may be “net of expenses”
 - North Carolina provides a subtraction for “Any amount included in federal taxable income under section 78 or section 951 of the Code, net of related expenses.” N.C. Gen. Stat. 105-130.5(b)(3b).
- Other states have a more general disallowance provision
 - “No deduction shall be allowed for any amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, regardless of whether that income was received or accrued during the taxable year.” Cal. Rev. & Tax. Cd. § 24425(a).
- California case concerning expense disallowance:
 - In *Apple Inc. v. Cal. Franchise Tax Board*, 199 Cal App 4th 1 (2011), *petition for rev. den.*, 2012 Cal. LEXIS 324 (2012), the California Court of Appeals, affirming a superior court decision, held that a state corporate income/franchise taxpayer successfully showed that its loan interest expenses were allocable to its taxed domestic earnings, rather than to its non-taxed dividends received from foreign subsidiaries, as the dominant purpose of the underlying borrowings was to fund its domestic operations.

Tax Base - Related Party Expense Disallowance

- Generally, a requirement to add back otherwise deductible expenses that arise as a result of certain related company transactions, unless an exception applies, such as if the related member is subject to tax in another state
- Example of a related party expense disallowance provision:
 - “For purposes of computing net income under this chapter, a taxpayer shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.”
Mass. Gen. L. Ch. 63, Sec. 311(b)
- Treaty Exception
 - May be part of “subject to tax in another state” exception
 - Some states merely require that payee be *located* in a treaty country
- Generally, a “comprehensive income tax treaty” may be defined as:
 - “a convention or agreement, entered into by the U.S. and approved by Congress, with a foreign government for the allocation of all categories of income subject to taxation or the withholding of tax on interest, dividends, and royalties for the prevention of double taxation of the respective nations’ residents and the sharing of information.” See, e.g., *Ga. Code. Ann. § 47-7-28.3(a)(1)*.

Filing Methods & Apportionment

Filing Methods

- Worldwide combined reporting
 - Held constitutional in *Container* and *Barclays Bank*, but no state requires worldwide combined reporting without providing water's-edge election
- Water's-edge reporting
 - Elected in several states – e.g., California, Idaho, Massachusetts, Utah
 - Required in many states – e.g., Illinois, Michigan, Minnesota, Wisconsin
 - Some states exclude all foreign corporations from their unitary returns filed on a water's edge basis; however, many states still include foreign corporations under certain circumstances

Filing Methods - Foreign Entity Inclusion

- Some typical rules for inclusion of foreign entities:
 - A foreign corporation may be included in a unitary return if it is subject to federal income tax or required to file a federal income tax return
 - A foreign corporation may also be included in a unitary return to the extent of its ECI
 - A foreign corporation with no ECI may be included in a unitary return to the extent of its U.S. source FDAP income
 - A foreign corporation may be included in a unitary return to the extent that 20% or more of its activity is within the US
- Some states will look at the average of the corporation's property and payroll factors (other states may use all 3 factors)
 - Another approach is whether the corporation has less than 80% active foreign business income

Filing Methods - Foreign Entity Inclusion

- A CFC may be included in a unitary return to the extent of its subpart F income
 - In California, a CFC is included in the unitary return based on the ratio of its subpart F income to current year E&P
 - In West Virginia, the income of a CFC is included to the extent of its subpart F income, but any income that was subject to an effective rate of tax in a foreign country that is greater than 90% of the maximum federal rate is excluded (i.e., “high tax CFC exception”)

Filing Methods - Foreign Entity Inclusion

- Some states are also including a foreign corporation in the unitary return if it is incorporated or doing business in a “tax haven” jurisdiction (e.g., AK, DC, MT, and WV)
 - In Alaska, a tax haven jurisdiction is a country that does not impose an income tax, or that imposes an income tax at a rate lower than 90% of the US rate
 - For the Alaska tax haven provision to apply, the foreign corporation must either: (1) have 50% or more of its sales, purchases, or payments of income or expenses, exclusive of payments for intangible property, made directly or indirectly to one or more members of the unitary return; or (2) not conduct any significant economic activity
 - In the District of Columbia, the definition of a tax haven means a jurisdiction that may have one of statutorily enumerated traits.
 - In Montana, the list of tax haven countries is set forth by statute and is updated as necessary
 - In West Virginia, the list of tax haven countries is based on the OECD tax haven designations

Filing Methods - Foreign Entity Inclusion

- A newer concept is the inclusion of a foreign corporation in a unitary return if it earns more than 20% of its income, directly or indirectly, from intangible property or service related activities, the costs of which are deductible against the business income of other members of the unitary group (e.g., DC, MA, and WV)
 - Inclusion is limited to the extent of the income and apportionment factors related to such intangible property and service related activities
 - In the District of Columbia, the provision is limited to foreign corporations that are residents of a country that does not have a comprehensive income tax treaty with the U.S.
 - In West Virginia, the provision does not apply to income that is exempt from federal income tax pursuant to a comprehensive income tax treaty with the U.S.

Apportionment - Throwback

- Throwback
 - If taxpayer is not taxable in destination country, sales may be thrown back to state of origin
 - Under the MTC, “[a] taxpayer is taxable in another State if (1) in that State he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that State has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so.”
 - “State” is defined to include a foreign country
- What is the appropriate standard to determine if a foreign country has “jurisdiction to subject the taxpayer to a net income tax”?
- Should P.L. 86-272 be used to determine if a taxpayer is “taxable” in a destination jurisdiction outside the U.S.?
 - California does not apply P.L. 86-272 to foreign commerce
 - Thus, solicitation activity in a foreign country is sufficient to create nexus and prevent throwback in California (however, note, Puerto Rico is treated as a “state”)

Apportionment - Factor Representation

Issue: Is inclusion of foreign-source dividend, interest and royalty income without appropriate factor relief unconstitutional?

- No – *NCR Corp. v. Taxation and Revenue Dept. of the State of New Mexico*, 856 P.2d 982, cert. denied 512 U.S. 1245 (1994)
- No – *NCR Corp. v. South Carolina Tax Comm'n*, 402 S.E. 2d 666 (S.C. 1991), cert. den., 114 S.Ct. 2763, (1994)
- No – *NCR Corp. v. Comm'r of Rev.*, 438 N.W. 2d 86 (Minn., 1989)
- No – *Conoco Inc. v. State of New Mexico Taxation and Revenue Department*, 931 P.2d 730 (New Mexico 1996)
- Yes – *Tambrands, Inc. v. State Tax Assessor*, 595 A.2d 1039 (Maine 1991)
- No – *E.I. DuPont deNemours v. State Tax Assessor*, 595 A. 2d. 1039 (Maine 1996), ruling on the “Augusta Formula,” which was devised after the *Tambrands* case
 - The Augusta Formula allows exclusion of 50% of dividends from foreign subsidiaries, but without factor relief

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