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Move forward with confidence—State implications of tax reform
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Filing methods, state apportionment, and tax reform – New issues and considerations

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Agenda

• Introduction
• Application of State Filing Methods in the Context of Tax Reform
• Application of Apportionment in the Context of Tax Reform
Application of State Filing Methods in the Context of Tax Reform
General Default Filing Methods by State

Note: This map represents general default filing methods for affiliated groups and does not consider industry-specific or elective provisions.
Worldwide Reporting – In General

• Most states limit the combined filing group to corporations formed or doing business in the United States (water’s-edge reporting). However, approximately 9 states permit worldwide reporting at the taxpayer’s election
  o These states vary on whether they default to worldwide or water’s-edge, but provide elections for the non-default method
  o No states currently require worldwide reporting

• Typically, under worldwide reporting, state tax is computed based on the combined income and apportionment of all global affiliates who are unitary and meet common ownership thresholds
  o Intercompany transactions, even those between US and foreign entities, are generally deferred or eliminated under worldwide reporting
Worldwide Reporting – As Applied to Transition Tax

The following are states where dividends received by U.S. corporations from greater-than-80% owned foreign corporations are generally not eligible for a 100% DRD or exclusion

<table>
<thead>
<tr>
<th>States With Limited Foreign DRD Provisions</th>
<th>IRC Conformity Method</th>
<th>Default Filing Method</th>
<th>Worldwide Option?</th>
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<tbody>
<tr>
<td>Alaska</td>
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<td>California</td>
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<tr>
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<td>Vermont</td>
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</tbody>
</table>

Note: This matrix identifies general IRC conformity and filing methods for states with limited foreign DRD provisions. The filing methods do not consider industry-specific or elective provisions besides worldwide combined reporting.
Worldwide Reporting – Potential Benefits and Considerations

• Potential Benefits
  o May eliminate deemed or actual dividends in states that otherwise provide less than a 100% DRD on foreign dividends
  o Forces apportionment factor representation

• Considerations
  o Taxed on worldwide income and committed to such for the statutory period of time
  o Tracing of earning and profits from historic water’s-edge years
  o Ability to change an existing election given the binding nature. Would reasonable cause exist?
  o Elimination may not apply if dividend is paid from a non-unitary affiliate
  o Due date for making a worldwide or water’s-edge election
Worldwide Reporting – California Considerations

Treatment of Repatriations

**General Rule:**
- 75% DRD

**Sample Considerations:**
- Prior worldwide years
- California PTI ordering rules
- Interest offset rule
- Factor representation/sourcing
- Impact of tiered CFCs

**Water’s Edge**
- US
- CFC

**Worldwide**
- US
- CFC

- 100% Elimination
- Prior water’s edge years
- Acquired CFCs
- Non-unitary CFCs
Separate-Entity and 80/20 Filing Methods

• Separate-entity filing requirements and 80/20 carve-out rules present unique opportunities to impact both transition tax and GILTI

• Particularly applicable to GILTI because of its prospective nature (presents opportunity to restructure) and possible impact on a larger number of states as compared to transition tax

• For states with rolling conformity, approximately 11 have default separate-entity filing requirements and 7 have 80/20 carve-out rules

• 80/20 Rules
  o Certain combined reporting states exclude corporations that have less than 20% of their activity within the US, regardless of country of incorporation
  o Factors considered in measuring foreign versus US activity vary by state
Separate-Entity and 80/20 Filing Methods – Potential Benefits and Considerations

• Potential Benefits
  o May impact taxability of transition tax and/or GILTI inclusion

• Considerations
  o Alignment of legal entities and activities to achieve benefit
  o Specific factors considered by relevant states for determining 80/20 status
  o Impact of IRC Section 965(a) and/or GILTI inclusion on the 80/20 determination
  o Taxability of subsequent dividends from the 80/20 company to the US group
Application of Apportionment in the Context of Tax Reform
Apportionment Considerations – Transition Tax

• Apportionment factor representation to the extent income is included in state tax base (either as Subpart F or subsequent distribution)
  o Approximately 16 states do not provide a 100% DRD or exclusion for dividends received from greater-than-80% owned foreign corporations

• Considerations
  o Impact of inclusion in sales factor denominator
    ▪ Excludable as an extraordinary or unusual transaction
  o Impact of inclusion in sales factor numerator
    ▪ Under cost of performance, dividends generally sourced to company’s headquarters or based on location of treasury operations
    ▪ Market-based sourcing provisions
Apportionment Considerations – GILTI

• State tax treatment of GILTI
  o Dividend subject to state DRD?
  o Active trade or business income?

• Considerations
  o Inclusion of apportionment factors to the extent GILTI is included in state taxable income
  o Alternative apportionment
  o Structural Planning
Factor Representation – Alternative Apportionment

Alternate Apportionment Provisions
• State cases have been decided under “discretionary authority” and/or “alternate apportionment” provisions.
• If the standard apportionment provisions do not fairly represent the taxpayer’s business in the state...

Detroit Method
• Courts have ruled that this method should be applied under the general theory that income included in the tax base should get factor representation.
• For example, if the US Corp owns 50% of the Foreign Sub, the Foreign Sub pays 50% of it's profits in dividends, then the US Corp would include 25% of the Foreign sub's property, payroll and sales in the denominators of its property, payroll and sales factors respectively.

Augusta Formula
• Compute tax liability using the higher of:
  • (1) the worldwide combined reporting, or
  • (2) the statutory apportionment formula applied to federal taxable income less foreign source dividends.
• If worldwide combined reporting yields a higher Maine income tax than its statutory water's-edge combined reporting computation, then the statutory computation is used, even though it includes foreign source dividends and provides no factor relief.
• Foreign entities held by Foreign Hold Co. Foreign Hold Co. nexus is limited to unitary states.
• Convert select CFCs to disregarded entity to flow foreign property and payroll to Foreign Hold Co.
• CFCs that are converted to disregarded entities will become fully taxable, but may create the potential to generate additional FDII Deduction.
Apportionment Considerations – FDII

• Foreign-Derived Intangible Income ("FDII") Deduction
  o FDII is income of US Corporation attributable to property sold or licensed to a foreign person for foreign use and services provided outside the United States
  o US Corporations include FDII in gross income but allowed a deduction under IRC Sec. 250 of 37.5% through 2025, 21.875% thereafter

• Considerations
  o Are sales related to FDII excluded from sales factor to the extent of deduction?
  o FDII data may allow for favorable state sourcing positions
    ▪ Market source services to foreign customers
    ▪ Source sales of TPP offshore
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