Multistate Tax
EXTERNAL ALERT

State Tax Implications of a Changing International Tax Landscape

October 16, 2014

Overview

On September 22, 2014, the United States Treasury ("Treasury") issued Notice 2014-52, *Rules Regarding Inversions and Related Transactions* ("Notice"). The Notice may be viewed as a response to several recent announcements by U.S. multinational companies, expressing their intentions to engage in inversion transactions. An "inversion" may actually cover a broad category of transactions but, as currently used in the press, the term appears intended to mean a merger or other transaction that among other things results in a U.S.-based company becoming a foreign corporation. Cross-broader mergers are generally driven by global business strategies and economic efficiencies. For example, an inversion may set the stage for future businesses or expanded product lines that will operate under the new foreign entity. These transactions are generally structured in conformity with the rules of the current Internal Revenue Code ("I.R.C.") and may indirectly result in certain U.S. tax benefits.

The Notice is the latest action in a summer filled with tax policy discussions and legislative proposals, both in the U.S. and abroad, centered on the international tax landscape. On the federal front, Senate Finance Committee member Charles E. Schumer (D-NY) introduced the "Corporate Inverters Earnings Stripping Reform Act of 2014" (S. 2786) on September 10, 2014, and House Ways and Means Committee Ranking Member Sander Levin (D-Mich.) and Senate Permanent Subcommittee on Investigations Chairman Carl Levin (D-Mich.) introduced similar versions of the "Stop Corporate Inversions Act of 2014" in the House (H.R. 4679) and Senate (S. 2360) in May 2014. At the state level, New Jersey State Senator Shirley Turner (D) introduced a series of bills that would deny state benefits to traditional international tax structures. Abroad, the Organization for Economic Co-Operation and Development ("OECD") recently released a series of non-binding recommendations to change domestic tax laws, treaties and other measures in an effort to ease government concerns related to tax base erosion and profit shifting. With change appearing to be at the forefront of the international conversation, some taxpayers have begun to consider the potential impact on their state tax postures as states begin to react to the international tax discussion.

In this Alert we summarize the Notice, other federal legislative proposals, the OECD's Base Erosion and Profit Shifting ("BEPS") Project, and related state proposals and initiatives that could impact foreign-based multinational corporations with investments in the U.S. as well as those considering U.S. investments.

Regulatory and Legislative Developments

Notice 2014-52, Rules Regarding Inversions and Related Transactions[1]

The Notice announced that the Treasury and the Internal Revenue Service ("IRS") will issue regulations under I.R.C. §§ 304(b)(5)(B), 367, 956(e), 7701(l), and 7874. The regulations are aimed at increasing the effective tax rate applicable to foreign acquirers of U.S. targets by limiting the opportunities to achieve tax efficiencies in the course of integrating the operations, management, and financing of the business; and at tightening the anti-inversion rules of I.R.C. § 7874. I.R.C. § 7874 generally limits the tax benefits of inversion by either: (1) treating the top-tier foreign corporation as a domestic corporation when the inversion involves at least 80 percent continuity of ownership in the foreign acquiring corporation by the shareholders of the acquired U.S. entity; or (2) barring corporate-level tax on specified "inversions gains" (i.e., gains or income derived from transferring U.S. property to related foreign persons) from being offset by tax attributes of the U.S. group when the inversion involves at least 60 but less than 80 percent continuity of ownership.

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[1] For additional information on the Notice, see our **September 23, 2014, International Tax Alert**.

The Notice provides that the regulations to be issued will apply for inversion transactions completed on or after September 22, 2014. Treasury says that it will continue to examine ways to reduce the tax benefits of inversions, and these actions may include additional guidance on transactions designed to shift income to related foreign persons as well as reviewing treaty and other international tax commitments.

Corporate Inverters Earnings Stripping Reform Act of 2014 ("CIESRA")[2]

CIESRA attempts to address inversions by tightening the earnings stripping rules of I.R.C. § 163(j), which generally limits deductions for interest paid on indebtedness to a related foreign person or guaranteed by a related foreign person where there is no U.S. tax imposed. CIESRA would broaden the application of I.R.C. § 7874 to not only initial acquisitions running afoul of I.R.C. § 7874, but also any acquisition made after the initial acquisition – even if the subsequent acquisition was not otherwise subject to I.R.C. § 7874. CIESRA would also institute an approval agreement regime. Under such a regime, an impacted entity would be required to annually pre-file an approval agreement with Treasury for 10 years regarding the terms of the entity's related-party transactions. The approval agreement would contain provisions to ensure the filing party has complied with I.R.C. §§ 163(j), 267(a)(3), 367, 482, and 845, and any other provision of the I.R.C. applicable to transactions between related persons and specified by the Treasury. Taxpayers failing to comply would be unable to claim any deductions or additions to basis or cost for related party transactions, and transfers of intangible property and cost-sharing agreements between the U.S. entity and a foreign related party would be disregarded.

The effective date of the CIESRA would be tax years beginning on or after enactment, and may retroactively apply to entities that were acquired by a foreign parent before enactment of I.R.C. § 7874.

Stop Corporate Inversions Act of 2014 ("SCIA")[3]

SCIA would tighten the anti-inversion rules of I.R.C. § 7874. The SCIA proposes to lower from "at least 80 percent" to "more than 50 percent" the I.R.C. § 7874 threshold of the share of stock ownership in an inverted company held by former shareholders or partners in the U.S. entity before the acquiring foreign corporation is treated as a domestic corporation for all purposes of the I.R.C. The SCIA also provides that an acquiring foreign corporation would be treated as a domestic company if management and control of the foreign group remains in the U.S. and 25 percent of the employees, employee compensation, income or tangible assets of the group are located or delivered in the U.S., regardless of the ownership continuity percentage.

The effective date of both the Senate and the House versions would be retroactive to May 8, 2014. The Senate bill would sunset after two years for transactions effective after May 8, 2016. According to bill sponsor Senator Levin, the sunset provision is intended to give Congress time to address inversions through comprehensive tax reform. The House version does not include a sunset provision.

New Jersey Anti-Inversion Bills

Since September 15, Senator Shirley Turner (D) has introduced a series of bills, specifically Senate Bills ("S") 2361, 2397, and 2398, and Senate Concurrent Resolutions ("SCR") 137, 139, and 144, aimed at denying state benefits to inverted companies and encouraging Congress to eliminate "wasteful federal tax loopholes." The bills and resolutions are summarized below.

S 2361 would prohibit the state of New Jersey from granting any contract or subcontract to an entity that is determined to be an inverted domestic corporation. While the Bill is not considered tax legislation, the State Treasurer is the sole party responsible for concluding whether an entity is an inverted domestic company. The State Treasurer is also granted broad discretion in making such a conclusion, as the State Treasury may consider "such other factors as the State Treasurer shall deem appropriate."

The other Senate proposals would preclude inverted companies from receiving certain New Jersey state benefits. **S 2397** would preclude inverted domestic companies from receiving state economic grants and other types of financial aid, and **S 2398** would prohibit New Jersey's pension fund from investing in companies that have been involved in a corporate inversion.

In the form of resolutions, **SCR 137** urges Congress and the Senate to enact H.R. 5278, which would ban federal contracts to inverted domestic corporations. **SCR 139** also urges Congress and the President to enact SCIA (see

[2] For additional information on CIESRA, see our **September 11, 2014, International Tax Alert**.
[3] For additional information on Senator Levin's and Representative Levin's proposals, see our **May 21, 2014, International Tax Alert**.

prior discussion above) while **SCR 144** calls on Congress and the President to enact legislation eliminating "tax loopholes." In those resolutions, "tax loopholes" are defined as "exceptions or oversights in the tax law that allow certain individuals or businesses to avoid paying taxes."

OECD's BEPS Project

On September 16, 2014, the OECD released seven draft deliverables as part of its BEPS Project, as announced in its Action Plan of July 2013. The OECD's BEPS effort is aimed at the perception of some that governments lose substantial corporate tax revenues because profits are shifted to favorable tax locations. The Action Plan sets out 15 areas for further analysis, including a summary of the key considerations to be addressed and the timetable for each area.[4] A portion of the seven draft deliverables provides recommendations, agreed to by the participating countries, to change domestic tax laws, treaties, and other measures to address government concerns about tax BEPS in cases involving "hybrid mismatch arrangements," amongst others, and perceived tax treaty abuses. The recommendations, however, are not binding and it will be up to Congress to decide whether to enact the proposals. The seven draft deliverables are summarized below.[5]

Action 1, Addressing the Tax Challenges of the Digital Economy - Identifies, without resolving, perceived tax policy challenges associated with a digital economy, such as: (1) taxable nexus created by the mobility of intangibles, users, and business functions; (2) attribution stemming from the collection and use of data; and (3) characterization of payments in certain digital economic business models.

Action 2, Neutralizing the Effects of Hybrid Mismatch Arrangements - Recommends changes to domestic legislation that would apply to "hybrid mismatch" arrangements and the OECD Model Tax Convention and its Commentaries, introducing a "fiscally transparent entity" provision that is similar in its purpose to Article 1(6) of the U.S. Model Income Tax Convention.

Action 5, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance - Focuses exclusively on attempting to measure substantial activity when evaluating preferential tax treatment for certain income arising from qualifying intellectual property and developing a framework for compulsory spontaneous information exchange on taxpayer-specific rulings related to preferential regimes.

Action 6, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances - Proposes changes to the OECD Model Tax Convention to prevent treaty shopping.

Action 8, Guidance on Transfer Pricing Aspects of Intangibles - Clarifies the definition of intangibles, provides proposed guidance on identifying transactions involving intangibles, and provides supplemental proposed guidance for determining arm's-length conditions for transactions involving intangibles.

Action 13, Guidance on Transfer Pricing Documentation and Country-by-country Reporting - Recognizes a perceived need to enhance transparency for tax administrators in the context of transfer pricing examinations; provides revised standards for transfer pricing documentation; and provides a template for country-by-country reporting of income, earnings, taxes paid, and certain economic measures.

Action 15, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties - Recommends the use of a multilateral instrument for purposes of revising the 3,000+ tax treaties now in force to reflect the BEPS Project conclusions.

Multinational State Tax Considerations

As federal and international tax policy participants continue to consider reform efforts, companies should be aware that the discussion has not been lost on the states. States have in recent years begun to attack traditional international tax structures through both legislative processes and enhanced enforcement efforts, in addition to continuing a trend toward expanding the tax base through "economic nexus"-type statutes and apportionment formulas aimed at taxing income based on customer location or "market" for service income and the location of "use" of intangibles for intangible income. In the discussion that follows we summarize certain state income/franchise and sales/use tax developments that companies, operating globally, may wish to consider when reviewing their multistate tax issues.

[4] For additional information on the OECD's Action Plan and the 15 areas of review, see our **July 19, 2013, International Tax Alert.**

[5] For additional information on the seven BEPS draft deliverables, see our **September 19, 2014, International Tax Alert** and **September 19, 2014, Transfer Pricing Alert.**

Income/Franchise Tax

Conformity to Federal Anti-Inversion Legislation or Pending Regulations

Many state corporate income tax regimes are affected by federal tax law and regulatory changes because they "piggy-back" off of the I.R.C. for purposes of administrative ease by either incorporating the I.R.C. in whole or in part, or by using federal taxable income as the starting point. When considering the state tax impact of a federal tax law or regulatory change, companies must be mindful of the particular state's level of conformity. States that do not specifically adopt federal taxable income as the starting point may require a foreign entity to recalculate income on a pro-forma basis without the inclusion of certain federal tax provisions/exemptions, e.g., income exempt pursuant to a U.S. tax treaty. This could produce a result where the foreign entity has no federal taxable income but has significant state taxable income. Varying levels of conformity may also expose companies to the risk that a single entity's presence in a state could effectively bring the income of a global group of affiliated entities within the taxing power of that state.[6]

"Tax Haven" Legislation

Some unitary states have changed their laws by adopting "tax haven" legislation in an effort to combat the state impact of perceived BEPS to other countries. States enacting such legislation generally identify, by name, jurisdictions considered to be "tax havens"[7] or deem a jurisdiction as a "tax haven" based on certain criteria.[8] Under these "tax haven" provisions, an otherwise water's-edge group is required to include the income of any company incorporated or doing business in a defined "tax haven." Alaska, Montana, Oregon, Rhode Island, West Virginia, and the District of Columbia have enacted versions of these laws.[9]

Intercompany Financing

Certain state tax agencies, such as Massachusetts', are particularly active in challenging domestic and international intercompany financing transactions. These challenges generally involve business purpose, economic substance, and debt-to-equity considerations performed by state courts that do not follow U.S. federal law or the application of such concepts to situations where U.S. authorities have not been traditionally applied.[10] Thus, intercompany debt arrangements that otherwise pass IRS scrutiny may be disregarded at the state level.[11]

Economic / Factor-presence Nexus

The expansion of economic and bright-line statutory nexus thresholds is particularly relevant for foreign entities that may lack a physical presence within the state and whose only connection may be sales to customers who are located within the state. When considering whether a foreign entity has the requisite sales activity within a state to

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[6] *See*, *Schlumberger Tech. Corp. v. State*, 331 P.3d 334 (Alaska 2014) (holding that Alaska has not adopted I.R.C. § 882(a)(1) by reference and the water's edge group is required to include 20 percent of foreign dividends in income without regard to whether such dividends are effectively connected income). For additional information on *Schlumberger*, see our **August 7, 2014, Alert**.

[7] Named "tax haven" jurisdictions under Or. Rev. State. § 317.715(2) are: 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.

[8] The Multistate Tax Commission defines a "Tax Haven" as a jurisdiction that: has no or a nominal effective tax rate; does not exchange information for tax purposes with other governments; lacks transparency; facilitates the establishment of foreign-owned entities without the need for a local substantive presence; excludes the jurisdiction's resident taxpayers from the benefits of the tax regime or prohibits enterprises that benefit from the tax regime from operating in the domestic market; or has created a tax regime that is favorable for tax avoidance. Multistate Tax Commission, Proposed Model Statute for Combined Reporting, § 1(I).

[9] Alaska Stat. § 43.20.145(a)(5); D.C. Code Ann. § 47-1810.07(a)(2)(F)(i); Mont. Code Ann § 15-31-323; Or. Rev. Stat. § 317.715(2); R.I. Stat. 44-11-4.1(d); W. Va. Code § 11-24-13f(a)(7). Regardless of approach, "tax haven" provisions have provided state tax agencies with the discretion to determine which jurisdictions are "tax havens."

[10] *See, e.g.*, *National Grid Holdings, Inc. v. Comm'r*, Mass. App. Tax Bd., No. ATB 2014-357 (June 4, 2014) (denying the taxpayer's interest deductions for payments under deferred subscription arrangements ("DSAs") with foreign entities on the basis that the DSAs did not qualify as true debt); *Kimberly-Clark Corp. v. Comm'r*, 981 N.E.2d 208 (Mass. App. Ct. 2013) (holding that a company was required to add-back: (1) certain interest expense deductions associated with its cash management loan agreement system, as the payments were not made on true debt; and (2) royalty expenses, as the intercompany royalty payments were without economic substance and the reorganization, giving rise to the royalties, was not motivated by a valid business purposes); *Gore Enter. Holdings, Inc. v. Comptroller*, 87 A.3d 1263 (Md. 2014) (holding that two out-of-state Delaware holding companies without physical presence in Maryland were required to pay Maryland corporate income tax on their royalty and interest income because they did not have economic substance as separate business entities apart from their parent company, a Maryland taxpayer).

[11] *See*, *National Grid U.S. Service Co. v. Comm'r,* Mass. App. Tax Bd., No. ATB 2014-630 (Sept. 19, 2014) (holding that neither state statutes nor applicable case law support the conclusion that an IRS post-audit closing agreement would require the Tax Board to rule that payments made under the DSAs were deductible interest for Massachusetts tax purposes).

satisfy a bright-line statutory nexus threshold, such as California's and New York's, one must be careful to remember that the state's apportionment sourcing provisions must be taken into account, paying particular attention to jurisdictions utilizing market-based sourcing for services and intangible transactions, as well as provisions that source sales of tangible personal property to the ultimate shipping destination regardless of where title transfer occurs (unless that state extends P.L. 86-272 protection to foreign entities). In both types of situations, transactions that do not generate U.S. source income for federal income tax purposes may be considered sales sourced to a particular state for purposes of applying a bright-line statutory nexus threshold.

Multistate Tax Commission's ("MTC's") Arm's-Length Adjustment Service ("ALAS") Project[12]

The ALAS Advisory Group is designated to lead the MTC's project to develop a multistate transfer pricing service. Many states have the ability to evaluate and potentially challenge intercompany transfer pricing arrangements through arm's-length statutes and regulations similar to I.R.C. § 482, including the Treasury regulations thereunder. In addition, states may have statutes providing discretionary authority to adjust income, statutes requiring the add-back of certain intercompany payments, and statutory or judicial economic nexus principles. However, state taxing authorities have had varying levels of success challenging and litigating transfer pricing arrangements, and often do not have in-house personnel and resources to conduct transfer pricing studies. The ALAS project came about in an effort to enable states to pool resources to secure economic expertise to support arm's-length issues on audit and during litigation in addition to considering arm's-length enforcement efficiencies and improvements (e.g., information sharing, training state tax agency audit staff to conduct non-economic reviews, increased tax return disclosure requirements, and standardized information data requests). While the project is still in its development phase, the timeline calls for an ultimate goal of submitting a proposal design for full MTC approval in July 2015, with implementation shortly thereafter if approved.

Regardless of the ultimate result of the ALAS project, states are currently considering transfer pricing issues not only in the context of interstate transactions, but also international transactions that may otherwise withstand IRS scrutiny.[13]

Sales/Use Tax

These developments and tax agency initiatives are also changing the indirect tax landscape for foreign-based multinational corporations. Particularly relevant are those states that expand nexus beyond the traditional physical presence standard applicable to the most common form of U.S. indirect tax - sales/use tax. Certain states have enacted "click-through" nexus provisions, which create a presumption of nexus for out-of-state sellers who compensate an in-state company based upon a percentage of sales from referrals through the in-state company's website. The out-of-state seller may rebut the presumption provided it can document that the in-state company is not actively soliciting sales within the state on the out-of-state seller's behalf. Additionally, some states have enacted "affiliate nexus" statutes, which confer nexus upon an out-of-state seller who is under common ownership with an in-state affiliate when the entities share common logos and trademarks or the in-state affiliate otherwise engages in activities that are deemed to expand the marketplace on behalf of the out-of-state seller. States are not uniform in their enactment of these nexus provisions.

Proposals for expanding sales/use tax nexus can also be seen at the federal level. The U.S. Senate passed the Marketplace Fairness Act ("MFA"), which if adopted into law would generally allow Streamlined Sales and Use Tax Agreement member states as well as states adopting "minimum simplification requirements" to require remote sellers (i.e., sellers that have no physical presence in a particular state) to collect and remit sales/use taxes on sales to in-state residents. The MFA would provide an exemption for sellers with annual gross receipts from U.S. remote sales of $1,000,000 or less.[14] While the U.S. House of Representatives has not brought the MFA to a vote, its Judiciary Committee continues to examine the MFA and similar proposals.[15]

A foreign-based multinational company that is a seller of tangible personal property, software, or other digital products should be aware that a seller not only needs to identify the states in which it has payroll, property, or

[12] For additional information on the ALAS Project, see our **October 13, 2014, Alert**.
[13] *See*, *National Grid U.S. Service Co. v. Comm'r,* Mass. App. Tax Bd., No. ATB 2014-630 (Sept. 19, 2014) (holding that neither state statutes nor applicable case law support the conclusion that an IRS post-audit closing agreement would require the Tax Board to rule that payments made under the DSAs were deductible interest for Massachusetts tax purposes).
[14] For more information on the MFA, see our **May 7, 2013, Alert**.
[15] For more information on the House of Representatives Judiciary Committee's examination of the MFA and similar proposals, see our **March 16, 2014, Alert**.

representatives with a "regular and systematic" presence, but also identify states where it pays a commission to in-state companies for a referral to its website or has affiliates engaging in related business activities. These activities may result in a nexus determination by a state tax agency. Such a determination would then require the foreign-based multinational company to register with the state tax agency, file sales/use tax returns, pay sales/use tax, and collect sales/use tax from its customers and remit that tax to the taxing agency.

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