

A Look At State Income Tax Issues and Consequences of the Administration's Proposed International Tax Revisions



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I.R.C. Conformity

President Obama's fiscal year 2011 budget includes several proposed revisions to international tax provisions of the Internal Revenue Code—affecting deferred interest expense deductions, Subpart F income, and the “80/20 company” exception. These proposals, if adopted, could pose some complications at the state level, as this article by George J. Barry, of Deloitte Tax LLP, explains. The deferred interest expense is potentially the most problematic, in light of *Kraft v. Iowa*, which requires states to avoid discriminating in favor of domestic commerce even if the discrimination results from conforming to federal tax law.

A Look at State Income Tax Issues and Consequences Of the Administration's Proposed International Tax Revisions

BY GEORGE J. BARRY

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The U.S. Treasury Department released its “Greenbook” in February 2010 describing the tax proposals contained in President Obama's FY 2011 budget.¹ This whitepaper describes state income tax issues and consequences that would result from enactment of three of the proposed international tax provisions. These proposals are referred to throughout this whitepaper as:

- deferred interest expense deductions or interest expense deferral provision,

¹ See “General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals,” Department of the Treasury (February 2010) (hereinafter the “Greenbook”).

- treating excess returns associated with transfers of intangibles offshore as a new category of Subpart F income, and

- repeal of the “80/20 company” exception.²

A limitation on this whitepaper is that the U.S. Treasury Department has not yet provided many details for these various international tax proposals, so in projecting state income tax issues and consequences, it is obviously necessary to speculate to some degree as to how the proposed provisions are actually going to work.

DEFERRED INTEREST EXPENSE DEDUCTIONS

Of the three Obama administration proposals mentioned above, deferred interest expense deductions would appear to be the most widely applicable. This proposal would require U.S. corporate taxpayers to defer interest expense deductions associated with foreign income until the income is repatriated.³

For State Income Tax: A Significant Kraft Issue

For many states, simply conforming to the new interest expense deferral provision of the federal Internal Revenue Code (I.R.C.) could lead to challenges under the Foreign Commerce Clause of the U.S. Constitution.⁴ Application of the interest expense deferral rules by the states could result in deferring interest expenses attributable to foreign subsidiaries but not those attributable to domestic subsidiaries. This would appear to be facially discriminatory in violation of the holding in *Kraft v. Iowa Dept. of Rev.*⁵ As with many other constitutional law issues that develop with respect to state taxation, the ultimate resolution could take a long time, perhaps years, to develop.

The U.S. Supreme Court decision in *Kraft* has sensitized the tax community over the last 18 years to the requirement under the Foreign Commerce Clause that state income tax provisions not discriminate in favor of domestic commerce over foreign commerce, even if the discrimination was entirely the result of conforming to the I.R.C. In *Kraft*, the U.S. Supreme Court held that the state of Iowa could not tax a U.S. corporate taxpayer's dividends from foreign subsidiaries, since the state's tax law allowed a deduction for dividends from U.S. domestic subsidiaries. It did not matter that the discrimination against foreign subsidiary dividends and in favor of domestic subsidiary dividends was embedded in the I.R.C. and that the Iowa result was merely a matter of

conforming to that code.⁶ The court held that the Foreign Commerce Clause prohibited Iowa from discriminating against foreign commerce (i.e., the ownership by Kraft of foreign subsidiaries) and in favor of domestic commerce (i.e., the ownership by Kraft of U.S. subsidiaries).⁷

The *Kraft* decision addressed the issue only for separate company states that conformed to the I.R.C. §243 dividend deduction provisions. The response in these states since 1992 has generally been to recognize the need to establish subtraction modification provisions for dividends from foreign corporations that at least match the deductions granted in the I.R.C. for dividends from U.S. corporations.⁸ The *Kraft* case also did not impact all separate company states equally. The discrimination in *Kraft* resulted from the fact that the corporate taxpayer received the same deduction for Iowa purposes for its U.S. domestic dividends as it did under the I.R.C. Therefore, the *Kraft* decision was generally not a problem for states unless they conformed to the I.R.C. §243 dividend deduction.

Since *Kraft*, a line of state court cases has held the decision to be inapplicable to states that use domestic

⁶ Under I.R.C. §243, corporate taxpayers are generally allowed a deduction for federal income tax purposes for dividends received from domestic corporations that are in the same affiliated group as the taxpayer (some exceptions apply). Deductions at a reduced percentage are allowed for dividends from corporations that are not in the affiliated group. Under I.R.C. §245, corporate taxpayers are allowed deductions in certain circumstances for dividends received from foreign corporations in which they own at least a 10 percent interest. The portion of the dividend that is deductible depends on the degree to which the income of the foreign corporation is from a U.S. trade or business and also varies based on whether or not the foreign corporation is wholly owned by the taxpayer. As explained by the U.S. Supreme Court in *Kraft*:

In adopting the federal pattern, Iowa also allows a deduction for dividends received from a foreign subsidiary if the dividends reflect business activity in the United States. Accordingly, while the dividends of all domestic subsidiaries are excluded from the Iowa tax base, the dividends of foreign subsidiaries are excluded only to the extent they reflect domestic earnings. In sum, the only subsidiary dividend payments taxed by Iowa are those reflecting the foreign business activity of foreign subsidiaries.

Kraft, 505 U.S. at 77.

⁷ *Kraft*, 505 U.S. 71, 82 (1992). See also *Dart Industries Inc. v. Clark*, 657 A.2d 1062, 1066 (R.I. 1995) (citing *Kraft*, the Supreme Court of Rhode Island held, “Rhode Island’s §44-11-11 treats dividends paid by a foreign corporation less favorably than those paid by domestic corporations. Although the Rhode Island and Iowa statutes differ in minor respects, the fatal flaw in the Iowa statute is present in §44-11-11: a preference for domestic commerce over foreign commerce. See *Kraft*, 505 U.S. at 79, 112 S. Ct. at 2370 As such, we are compelled to hold that §44-11-11 ‘facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause.’ ”)

⁸ See, e.g., *Policy Statement on Kraft Decision*, Iowa Dept. of Ref. and Fin (Dec. 14, 1992) (“In view of . . . [*Kraft*], the Iowa Department of Revenue and Finance will apply the same criteria for a dividend received deduction for foreign source dividends [as] section 243 of the Internal Revenue Code does for domestic dividends.”); and S.C. Code §12-6-1130(11) (“A dividend from a foreign corporation is treated as a dividend from a domestic corporation for the purposes of the dividends received deduction under Section 243 of the Internal Revenue Code.”).

² Since this article was written, the repeal of the 80/20 company exception for federal purposes has been included in the American Jobs and Closing Tax Loopholes Act of 2010, which passed the House of Representatives on May 28 and was pending in the Senate as of June 14.

³ See FY 2011 Greenbook, at 39. Limiting the deferral to interest expense is a change from the FY 2010 budget proposal. That proposal, which was not pursued, would have deferred interest, general and administrative, and stewardship expenses. See FY 2010 Greenbook, at 29.

⁴ U.S. Const., art. I, §8, cl. 3.

⁵ *Kraft v. Iowa Dept. of Rev.*, 505 U.S. 71 (1992).

combined apportionment for corporate income tax.⁹ The rationale for these cases, which was suggested by a footnote in the Supreme Court's *Kraft* opinion,¹⁰ has been that domestic combined reporting states, by use of that methodology, are currently taxing earnings of the corporate taxpayer's U.S. subsidiaries and affiliates. Therefore, the taxation of foreign subsidiary dividends by such states, even if they conformed to the I.R.C. §243 domestic dividend deduction, would not represent discriminatory treatment of the taxpayer's foreign commerce by comparison to its domestic commerce.¹¹

However, the cases mentioned above coming out of some domestic combined reporting states do not resolve the question of the taxability of dividends from foreign corporations where the level of ownership of the foreign corporation does not meet the state's threshold for inclusion of a domestic corporation in the combined return (i.e., ownership that is below the level at which domestic "water's-edge" combined reporting occurs). Where such states conform to I.R.C. §243, dividends from domestic corporations not meeting that threshold may still be entitled to at least a partial dividends received deduction that does not apply to dividends from foreign corporations. Therefore, a taxpayer with dividends from a foreign corporation that does not meet the required ownership for domestic combined reporting may successfully litigate the discrimination issue in one of these states. In that litigation, the taxpayer could argue that it is a violation of the Foreign Commerce Clause to tax such foreign dividends while allow-

⁹ See *Appeal of Morton Thiokol Inc.*, 254 Kan 23, 38 (1993) ("Revenue correctly points out that *Kraft* 'does not address the taxation of foreign dividends by domestic combination states.' Clearly, *Kraft* does not hold that the taxation of foreign dividends by a combination method is facially unconstitutional."). See also the California Court of Appeal's interpretation of *Thiokol in Fujitsu IT Holdings Inc. v. California Franchise Tax Bd.*, 120 Cal. App. 4th 459, 483 ("In *Thiokol* . . . the court limited the holding in *Kraft* to states that do not use a combined water's-edge or domestic combination reporting method."). See also *El. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, 88 (1966) ("Far from discriminating against foreign commerce, Maine's water's edge combined reporting method provides a type of 'taxing symmetry' that is not present under the single entity system. . . . Because the income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine as part of the parent company's income, the inclusion of dividends paid by foreign subsidiaries does not constitute the kind of facial discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax scheme in *Kraft*."). Other courts have found that the taxation of foreign-source income is not invalid under *Kraft* where the consolidated or combined methodology is used. See *Caterpillar Inc. v. Minnesota Commr. of Rev.*, 568 N.W.2d 695 (Minn. 1997) and *Caterpillar Inc. v. Dept. of Rev. Admin.*, 144 N.H. 253 (1999), each involving interest and royalty payments made by a foreign subsidiary.

¹⁰ *Kraft*, 505 U.S. at 80, n.23.

¹¹ See the California Court of Appeal's interpretation of *Thiokol in Fujitsu IT Holdings Inc.*, 120 Cal. App. 4th at 483 ("The *Thiokol* court reasoned that a combined reporting state (i.e., water's-edge) does not discriminate against foreign subsidiaries. While the foreign subsidiary's dividend payments to the unitary business are taxed, its total income is not included in the unitary business overall income. Conversely, while a domestic subsidiary's dividend payments to the unitary business are not taxed, its total income is included in the unitary business overall income. Thus, no discrimination against foreign commerce occurs.").

ing a deduction for dividends from domestic corporations the ownership of which also does not meet the required level for domestic combined reporting.

Likewise, in trying to anticipate to what degree the domestic combined reporting states might be able simply to conform to new I.R.C. interest expense deferral provisions, these same issues would potentially apply. In other words, it seems likely that these states could conform to the proposed new interest expense deferral provisions for a taxpayer that has an investment in a foreign corporation that is at an ownership level (usually more than 50 percent) at which domestic combined reporting would apply. However, if that conformity is structured so broadly that it would also encompass interest expenses related to investments in foreign corporations that are below the level of ownership at which domestic combined reporting occurs, then there could be a Foreign Commerce Clause discrimination problem with that conformity provision as applied to those minority holdings.

Drawing upon the foregoing, the questions raised by the proposed interest expense deferral provision are as follows:

- Is there any potential in the year the interest expense deductions are deferred to create a new element of discrimination against a U.S. corporate taxpayer's foreign business interests by comparison to its domestic business interests?

- Is the discrimination cured by the fact that under the interest expense deferral proposal there is the possibility of the interest expense deductions being recognized in the year the foreign income is repatriated?

- If the interest expense deferral proposal does have the potential to create a new element of discrimination against a corporate taxpayer's foreign business interests and if the recognition of the interest expense deductions does not cure the discrimination, what (at least in broad outline) might the remedy look like in the affected state statutes?

The Challenges of Conforming

Setting aside the combined reporting states, to the extent that states were to passively conform to the enactment of a federal interest expense deferral provision, it would seem that there could be a *Kraft* (Foreign Commerce Clause anti-discrimination) problem in the first year (2011) after enactment of the federal provision. A state that simply conforms to the newly amended I.R.C. would be depriving corporate taxpayers that have foreign subsidiaries of current interest expense deductions while not depriving otherwise identical corporate taxpayers with only domestic subsidiaries of any of their current interest expense deductions.

Under the interest expense deferral proposal, at some later year in the corporate earning and distributions cycle, the interest expense deductions deferred in 2011 would be recognized or partially recognized to the extent foreign income is repatriated at the federal level.¹² The same policy of passive conformity in the

¹² We have heard from our colleagues in the international tax practice that future recognition of deferred interest expense deductions based on repatriation is likely to be very difficult to achieve for most taxpayers. We are not taking that difficulty into account in this discussion, but are instead accepting at face value that recognition of deferred interest expense

state that caused the interest expense deduction deferral to apply in 2011 would presumably result in some recognition of the interest expense deductions for that state's income tax purposes in the later year. However, the possibility of restoring interest expense deductions in later years does not seem likely to overcome the discrimination against foreign commerce that occurs in the earlier deferral year.

In considering why the possibility of future recognition of the deferred interest expense deductions may not cure the discrimination, it is critical to focus on the basic difference after *Kraft* between the federal income tax approach to the corporate taxpayer's foreign subsidiaries and the state income tax approach. The federal income tax system taxes the foreign subsidiary dividends as a result of the income of the foreign subsidiary having been deferred in the year when actually earned. The same federal income tax system deducts the domestic subsidiary dividends as a result of the underlying subsidiary income having already been taxed for U.S. purposes when it was earned. Therefore, the logic of the Obama administration's deferred interest expense proposal is that current interest expense deductions associated with foreign business income that will be recognized when repatriated in the future should themselves be deferred. On the other hand, it is perfectly logical that there would be no deferral of U.S. corporate taxpayer interest expense deductions related to U.S. subsidiary income, because that income is being recognized for U.S. income tax purposes as earned; it is not being deferred until dividends are paid.

This distinction at the heart of the federal income tax system was exactly the one that was rejected when applied to the state income tax system in *Kraft* as being discriminatory in violation of the Foreign Commerce Clause. Therefore, if interest expense deductions are disallowed in 2011 for taxpayers with foreign subsidiaries but not for identical taxpayers with domestic subsidiaries, it would seem unlikely that a separate company state could defend this treatment by arguing that the disallowed interest expense deductions will be recognized in the future when foreign business income is repatriated.

Will States Look to Other Remedies?

The above analysis suggests that if a state wanted to keep the tax revenue that would result from passively conforming to a newly enacted interest expense deferral provision, it would have to remedy the discrimination by extending the interest expense deferral in some equivalent manner to corporate taxpayers that have domestic, but not foreign, subsidiaries. Presumably, tax policy in such a state would also necessitate that the deferred interest expense deductions for these taxpayers that do not have foreign subsidiaries would also be recognized at some future year based on an event, whatever it might be, that is equivalent to the repatriation of earnings from foreign subsidiaries.

There would presumably be great complexity involved in crafting and administering state-level tax code provisions that would create a set of interest expense deferral rules and interest expense recognition rules that would apply uniformly to corporate taxpayers with

deductions can happen at some point and that it is more than just a theoretical possibility.

U.S. domestic subsidiaries and to those with foreign subsidiaries. This difficulty would likely have the ultimate result of inducing most states to "decouple" from the entire federal system of provisions for federal interest expense deferral and interest expense deduction restoration provisions. The greatest uncertainty in this situation lies in the potential for a slow response by many states.

The fact that the constitutional law considerations commend this "decoupling" may not be recognized and accepted promptly by the state tax policy makers. Some state policy makers may be influenced in the direction of possible constitutional error by the revenue increases that could result from disallowance of large amounts of interest expense deductions for corporate taxpayers that have foreign subsidiaries. This seems especially likely to happen in view of the fact that these additional revenues would result in many states simply by being passive, that is, states accepting without action the amendments to the I.R.C.

What could be expected is a number of years of controversy between the taxpayer community and tax administration community concerning these matters before many states are persuaded that the Foreign Commerce Clause will most likely preclude them from disallowing interest expense deductions for U.S. corporate taxpayers with foreign subsidiaries while not disallowing interest expense deductions for U.S. corporate taxpayers without foreign subsidiaries.

The emergence of this proposal at the federal level could be an occasion for state tax policy makers to reflect on their tax revenue loss resulting from interest expense deductions associated with foreign subsidiaries of their U.S. corporate taxpayers. If simple conformity to the new federal proposals for deferring interest expense is likely not to work at the state level because of *Kraft*, are there remedial provisions that might allow the states to capture some of the tax revenue that is currently lost because of interest expense deductions by U.S. corporate taxpayers associated with foreign subsidiaries? The answer is that foreign subsidiaries of the U.S. corporate state income taxpayer will have to be considered along with domestic U.S. subsidiaries in developing remedial provisions that will stand up to constitutional law scrutiny. The following example illustrates this point:

Example: Corporation A has both U.S. domestic subsidiaries and foreign subsidiaries operating as part of its worldwide business. Corporation A files income tax returns in many states. Some are on a domestic combined reporting basis, including all of its U.S. subsidiaries (matching its federal consolidated return). One or two are on a worldwide basis, including the foreign subsidiaries as well as all of the companies on the federal consolidated return. Twenty of the returns are on a separate company basis for Corporation A alone. In some of these twenty separate company states, all of the U.S. subsidiaries are themselves taxpayers. In others, some but not all are taxpayers. In a few of the separate company states, one of which is State X, none of the U.S. domestic subsidiaries of Corporation A are taxpayers.

State X is a "rolling conformity" state, i.e., whatever changes occur in the elements of the I.R.C. connected to the computation of taxable income automatically flow into the computation of Corporation A's State X liability. In 1992, after *Kraft*, State X leg-

isolated a subtraction modification for foreign dividends. Now that it sees the potential for increasing revenues by disallowing deductions for taxpayers such as Corporation A with respect to interest expenses associated with foreign subsidiaries, State X tax policy makers are interested in pursuing appropriate legislation in their own legislature. What would that legislation have to look like?

Answer. From a State X viewpoint, the legislation that it needs would *at least* have to recognize that the interest expense deductions of Corporation A associated with foreign subsidiaries are identical from a Foreign Commerce Clause perspective to the interest expense deductions of Corporation A associated with U.S. domestic subsidiaries, none of which are State X taxpayers. If State X determines as a matter of tax policy to disallow interest expense deductions to Corporation A related to its ownership and management and operation of foreign subsidiaries, then it would seem that it would have to do the same with respect to interest expense deductions associated with the ownership, management, and operation of the U.S. subsidiaries. Since the dividends from both sets of subsidiaries are deducted in arriving at Corporation A's taxable income in State X, this is by no means an illogical result from a tax policy viewpoint, though probably not one that is seen in many states at this time.¹³

Potential Scattering of Deferred Interest Expense Deductions

For state income tax purposes, another important variable that should be considered in evaluating the effect of the interest expense deferral proposal is the positioning, among the corporations in an affiliated group, of the interest expense deductions that would be deferred.

For the majority of corporate taxpayers, the reported liability and exposure for federal income tax purposes is reflected in the federal consolidated return for the year of the entire affiliated group. By contrast, the overall reported liability and overall exposure of taxpayers for state income tax is reflected on a diverse collection of returns. Some of these returns might match the federal consolidated return in terms of the group of companies that is reported. Others might reflect smaller sub-groups of companies than the federal consolidated

¹³ The constitutional flaw under the Foreign Commerce Clause that would result if State X in this example were to disallow certain interest expense deductions attributed to foreign dividends while not disallowing any interest expense deductions attributable to domestic dividends was recognized and explained by the Ohio Supreme Court in *Emerson Electric v. Ohio*, 90 Ohio St. 3d 157 (2002). In that case, while Ohio allowed a deduction for both foreign and domestic dividends, it required that the deduction for foreign dividends be reduced by 15 percent of the gross amount. The reason for the reduction was that 15 percent was deemed to be the amount of expenses that was required for production of the foreign dividends. No such reduction—15 percent or any other amount—was required for domestic dividends. The Ohio Supreme Court, citing *Kraft*, concluded that the unfavorable discriminatory treatment of foreign dividends by comparison to domestic dividends violated the Foreign Commerce Clause. *Emerson*, 90 Ohio St. 3d at 162.

return or, in some fact patterns, larger groups than the federal consolidated return. Still others are “separate company” returns of single corporations that are members of the federal affiliated group.

Because an enterprise takes on different shapes as a taxpaying entity in different states, the effect of the interest expense deduction deferral could vary based on earlier business decisions.

For federal income tax purposes, the tax effect of the proposed deferral of interest expense deductions would generally not vary based on the location of the deduction within the federal affiliated group. This is not true for state income tax purposes where a different tax cost could arise depending upon which entity within an affiliated group generated the deferred interest expense deduction and how that entity files. For example, if the deferred interest expense deduction is found in the common parent company of the federal affiliated group and that common parent company only appears on income tax returns in a few unitary states, then the related tax cost could be much different from the cost that would result if the deferred interest expense deductions were in an operating company that has nexus in every state.

The above analysis recognizes that, because an enterprise takes on different shapes as a taxpaying entity in different states, the effect of the interest expense deduction deferral could vary based on earlier business decisions that were made about the holding of debt among related entities. There is no particular policy reason why the interest expense deduction deferral should be allowed to have an overall larger or smaller tax effect based on such fortuitous circumstances.

Potential Valuation Issues Around Deferred Interest Expense Deductions

In those states in which the new federal mechanism of interest expense deferral and future interest expense recognition would apply, there will be valuation issues around the amount of the future state income tax benefits. At the highest level of analysis, these can be expected to parallel the valuation issue around the federal tax benefit. At this level, the question for state as well as federal purposes will be to assess the prospects that criteria for recognition of the interest expense deductions will ever be satisfied. Beyond this highest level valuation analysis, however, the state income tax system has the potential for necessitating a far more granular valuation analysis around the benefit of these deferred interest expense deductions than is likely to be required with respect to the federal income tax benefits.

The multiple aspects of the income tax computations of various states and the ongoing evolution of the net income tax laws in particular states will inevitably create some specific valuation issues with respect to deferred interest expense deductions. To perform this valuation function adequately could require a comprehensive periodic review at several levels of the state in-

come tax system to which a taxpayer with deferred interest expense deductions is exposed. The following paragraphs suggest some of the more obvious items that would have to be taken into account in that review.

The most straightforward aspect of such a periodic review, and the easiest to administer, will result from the need for taxpayers with deferred interest expense deductions in a particular state to monitor the state's income tax rate. As rates rise, the value of deferred interest expense deductions would as well.

Somewhat more challenging will be the need to monitor changes in the apportionment provisions. For example, the current trend among states is to move away from income producing activity and cost of performance sourcing of receipts from services and to a market-based approach. This can significantly increase or decrease a taxpayer's projection of apportionment for a future year, which of course would increase or decrease the value of deferred interest expense deductions in that future year.

Even more complex is the valuation analysis and the potential valuation issues that follow on a state's shift from separate company apportionment to combined apportionment, another current state income tax trend. Will states that legislate combined reporting for the first time at some year in the future even permit interest expense deductions to be taken on a deferred basis if the company was not a taxpayer in the state in the year in which the underlying interest expense was actually incurred?

Most dramatic, of course, would be the valuation effects of deferred interest expense deductions in states that abandon the net income tax system altogether. For example, if there are any additional states that take the tax policy path recently followed by Ohio and Texas in repealing their net-income-based franchise taxes, there is the potential for wholesale loss of the value of deferred interest expense deductions unless the state tax legislation makes some specific provision for a balancing adjustment in the computation of the new replacement tax.

In addition to the above items, which might be thought of as examples of the "direct" effects of projecting the recognition of interest expense deductions into the often changing state income tax computations in future years, there are also potential "indirect effects" to consider. A loss of current interest expense deductions creating greater current income could add value to net operating losses at the state level, given that the carryforward periods in many states are shorter than the twenty years generally available for federal income tax purposes. Similarly, taxpayers with state income credits that are at risk of out-living the credit carryforward periods, may be in a position to find new value in those credits as an immediate result of interest expense deduction deferral.

NEW CATEGORY OF SUBPART F INCOME

Another of the Obama Administration Budget proposals for FY 2011 seeks to create a new category of Subpart F income for amounts that are defined as "excess returns" associated with the transfer of intangibles

offshore to a controlled foreign corporation (CFC) in low tax foreign jurisdictions.¹⁴

If a U.S. corporation transfers intangible assets—for example a patent, trademark, or copyright—to a CFC, and the CFC then charges royalties back to the U.S. corporation or its U.S. taxpayer affiliates, the IRS under current law would typically rely on I.R.C. §482 to make an adjustment if it were to conclude that the royalties were too high and that the income of the U.S. corporation was therefore understated. The U.S. corporation would then routinely be required to report the increase in its federal taxable income to the various states in which the adjustment would have an impact on the state income tax liability. Of course, there are now a number of states in which a corporate taxpayer is generally precluded, usually with certain specific exceptions, from claiming a deduction for royalty expenses paid to related party payees.¹⁵ In these particular states, the I.R.C. §482 adjustment might not trigger a state income tax deficiency to be reported if and to the extent the royalty was not deducted in the first place.

The new proposal in the FY 2011 Budget would expand the definition of Subpart F income to include the excess return represented by the royalty received by the CFC if the CFC were in a low-tax jurisdiction. In addition, the foreign tax credit limitation provisions would be amended to establish that this particular category of Subpart F income would be consigned to its own foreign tax credit limitation basket. The proposal would apply only in circumstances that evidence excessive income shifting. The proposal is not specific about what would constitute an "excess return," nor is it specific about what would constitute a "low tax" jurisdiction or a "circumstance that evidences excessive income shifting."¹⁶

With this new category of Subpart F income, even if the IRS were to conclude that a royalty expense deduction between a U.S. corporate taxpayer and its related CFC in a low tax jurisdiction was excessive, it would no longer necessarily assert an adjustment directly against the U.S. corporation under I.R.C. §482. This is because the new Subpart F provision would bring the excessive royalty income back into the U.S. tax base automatically. Of course, if there is no federal adjustment under I.R.C. §482, then there would not be a federal change to report even in those states where the royalties are fully deductible. It is in these states that this particular item in the Obama administration budget proposal for FY 2011 may actually be beneficial for the affected taxpayers.

Most states provide a deduction or subtraction modification for "deemed dividends" that a U.S. corporate income taxpayer would include in its federal taxable income by reason of having an interest in a CFC that has Subpart F income. This state-level deduction or subtraction modification is similar to what is provided in most

¹⁴ See FY 2011 Greenbook, at 43.

¹⁵ Examples of states with these types of royalty expense disallowance provisions include New York and Illinois. N.Y. Tax Law §208.9(o), 35 Ill. Comp. Stat. 5/203(b)(2)(E-13).

¹⁶ However, administration officials have reportedly said they would regard a CFC as being low-taxed if it pays an effective tax rate of less than 10 percent and that a rate of return is excessive if it exceeds 30 percent. Kim Dixon, *Obama Tones Down Global Company Tax Goals* (Feb. 1, 2010), <http://www.reuters.com/article/idUSNO119192320100201>.

states, especially since the *Kraft* decision in 1992, for dividends from foreign subsidiaries.¹⁷ Therefore, the fact that the present Obama administration proposal is going to trigger additional Subpart F income is not likely to produce a significant detrimental state income tax effect for most U.S. corporate taxpayers. Generally, the Subpart F income would not in and of itself be expected to create significant incremental state income tax liability. One possible exception to the proposition that “deemed dividends” from Subpart F income do not generate significant incremental state income tax is California’s “indirect” taxation of Subpart F income as part of its water’s-edge election system.¹⁸ An analysis of the “indirect” taxation effect of Subpart F income would be warranted in every situation in which the proposal actually did lead to increases in Subpart F income and “deemed dividends.”

REPEAL OF FEDERAL “80/20 COMPANY” EXCEPTION

Under current provisions of the I.R.C., if interest or dividends that are not effectively connected to the conduct of a trade or business in the U.S. are paid by a U.S. corporation to a foreign corporation, then the interest or dividends would generally be subject to a 30 percent U.S. tax, which is enforced by a withholding requirement on the payor.¹⁹ There is an exception under current law to the application of the 30 percent tax and withholding if the U.S. corporation paying the interest or dividend has 80 percent or more of its gross income from “active foreign business income.” The 80 percent active foreign business income exception as applied to interest is prescribed in I.R.C. §§861(a)(1)(A) and 861(c)(1), and as applied to dividends is prescribed in I.R.C. §§871(i)(2)(B), 881(d), and 861(c)(1). In the federal income tax context, this is the so-called “80/20 company” exception. It is this exception that is proposed for repeal in the Obama administration budget for FY 2011.²⁰

¹⁷ Examples of states deductions for Subpart F income include the following provisions in Florida, Georgia, and Illinois. Fla. Stat. Ann. §220.13(1)(b)2.b, Ga. Code Ann. §48-7-21(b)(8)(A), 35 ILCS. 5/203(b)(2)(O).

¹⁸ Under Cal. Rev. & Tax. Code §25110(a)(6), California “indirectly” taxes Subpart F income as a part of the water’s-edge computation. The equivalent of California level taxable income of each CFC is factored by the ratio of that CFC’s Subpart F income for the year to its total earnings and profits. That portion of the CFC’s California equivalent income is then included in the unitary business income subject to apportionment. The apportionment values of the CFC are also drawn into the combined unitary business income computation by applying the Subpart F ratio described above.

¹⁹ Note that this is a tax on the gross amount of the interest and dividends. The tax and the withholding are in many cases reduced or eliminated entirely by the operation of treaty provisions between the United States and the country of domicile of the foreign corporation receiving the interest or dividend. The tax is generally prescribed by I.R.C. §881, and the withholding is generally prescribed by I.R.C. §1442.

²⁰ See FY 2011 Greenbook, at 47. This proposal was included in the Small Business and Infrastructure Jobs Act of 2010 (H.R. 4849), passed by the House of Representatives on March 24, and in the American Jobs and Closing Tax Loop-

There is no analogue in the state income tax system to the 30 percent U.S. withholding tax on the gross amount of interest and dividends. Thus, the proposed repeal of that exception should not have any *direct* state income tax effect. However, this Obama administration proposal for FY 2011 could potentially have an indirect effect on the membership of unitary business groups in certain states. Many states have their own provisions for the exclusion of so-called “80/20 companies” from their water’s edge or domestic unitary business groups, but these are commonly based on relative levels of traditional state apportionment values inside and outside the United States. This state “80/20 company” classification is different than the similarly designated federal “80/20 company,” which is based on satisfying the 80 percent active foreign business income test under I.R.C. §861(c). Unlike other states, however, Alaska, Wisconsin, and Michigan each has a unitary business group provision that does incorporate the federal “80/20 company” concept to define corporations that would be excluded from their respective unitary business groups.²¹ Therefore, the proposed repeal of the federal “80/20 company” exception may potentially have an *indirect* effect on taxation in these three states.

The exact impact on the unitary business group membership in Alaska, Wisconsin, and Michigan, and any other states that might be in process of incorporating the federal 80 percent active foreign business income exception, will depend on how the I.R.C. is amended in order to repeal that exception. Conceivably, if the “80/20 company” exception is repealed for federal income tax purposes, some corporate tax departments might conclude that they can stop monitoring and managing the level of “active foreign business income” of such companies, since there would no longer be any federal benefit in achieving that 80 percent or higher level. The failure to monitor the federal 80/20 requirements after repeal of the federal provisions could result in unexpected changes in the taxpayers’ combined reports for Alaska, Wisconsin, and Michigan purposes, and that, obviously, could be detrimental. Corporate tax departments will have to be mindful that this is an issue to be considered.

CONCLUSION

There are some very fundamental conceptual relationships between international tax concepts under the I.R.C. and state corporate income tax concepts. These include some matters that are elevated to levels of constitutional importance. They also include some very detailed issues of state statutory interpretation that are focused ultimately on which portions of a multinational business will actually be exposed to a state’s tax system. This whitepaper has been an initial effort to define some of the issues that could emerge if the current Obama administration proposals are adopted. It will undoubtedly be possible to do a more specific analysis and commentary when the proposals are actually framed as specific legislation at the federal level.

holes Act of 2010, which passed the House on May 28. Both bills were pending in the Senate as of June 14.

²¹ Alaska Stat. §43.20.073, Wis. Stat. §71.255(2)(c), Mich. Comp. Laws §208.1109(5)(c).

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