State Tax Implications of International Tax Reform

NCSL Executive Task Force on State & Local Taxation

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Presenters:

Scott Roberti, Ernst & Young, LLP (Moderator)

Karl Frieden, COST

Michael Mazerov, Center on Budget & Policy Priorities

Steve Wlodychak, Ernst & Young, LLP

Agenda

- **Key International Tax Provisions of the Tax Cuts and Jobs Act (P.L. 115-97) (TCJA)**
  - Foreign DRD (territorial taxation)
  - Transition Tax
    - Section 965 (c) deduction
  - Global Intangible Low-Taxed Income (GILTI)
    - Section 250 deduction
  - Foreign Derived Intangible Income (FDII)
  - Base Erosion Anti-Abuse Tax (BEAT)
- **Conformity with TCJA International Tax Provisions** (Center on Budget & Policy Priorities Perspective)
- **Conformity with TCJA International Tax Provisions** (Business Perspective)

Key International Tax Provisions of the TCJA

Foreign DRD (Territorial Taxation)

- **What It Does**
  - 100% dividend received deduction (DRD) for dividends received by 10% (or more) US shareholder from foreign corporations
  - Future foreign earnings (unless otherwise taxed) are thus “exempt” from U.S. tax moving the U.S. to a quasi-territorial regime
  - A DRD also provides relief from double taxation on income previously taxed
- **Related IRC Provisions**
  - IRC §245A (new) provides the DRD

Transition Tax on Accumulated Foreign Earnings

- **What It Does**
  - One-time inclusion in gross income (Subpart F income) of the post-1986 accumulated earnings and profits of all foreign corporations of U.S. shareholders
  - Reported on return of U.S. shareholders for the last taxable year of the foreign corporation beginning before January 1, 2018 (i.e., 2017)
  - Provides a deduction to effectuate a federal tax rate of:
    - 15.5% for earnings of cash and cash equivalents
    - 8% for all other earnings
    - Rate reduced from 35% rate

Transition Tax on Accumulated Foreign Earnings

- **What It Does (con’t)**
  - Taxpayer can elect to pay the transition tax over eight years
- **Related IRC Provisions**
  - IRC §965(a) provides the transition tax
  - **IRC §965(c) provides the deduction**
  - IRS press release (March 13, 2018) and FAQs requiring transition tax and associated deduction to be reported on a separate statement attached to the taxpayer’s return

Global Intangible Low Taxed Income (GILTI)

- **What It Does**
  - Immediately taxes foreign source earnings (of all aggregated foreign entities) in excess of a 10% rate of return on fixed assets
  - Tax is at a reduced rate by providing a 50% deduction (reduced after 2025 to 37.5% deduction).
    - Federal rate of 10.5% (13.125% after 2025)
- **Related IRC Provisions**
  - IRC §951A provides the GILTI inclusion in gross income
  - IRC §250 provides the GILTI deduction

Foreign Derived Intangible Income (FDII)

- **What It Does**
  - Provides a reduced rate of tax (by means of a deduction) on certain specified income (e.g., royalties, patents, trademarks) that U.S.-based companies earn from servicing foreign markets
    - Returns in excess of 10 percent of fixed assets form the basis for the calculation
    - 37.5% through 2025 (13.125% federal rate)
    - 21.875% after 2025 (16.40625% federal rate)
  - Operates similarly to European "patent box"
- **Related IRC Provisions**
  - IRC §250 provides the FDII deduction (and also the GILTI deduction)

Base Erosion Anti-Abuse Tax (BEAT)

– **What It Does**
  - Imposes a new federal minimum tax on large corporations
    - Over $500 million in gross receipts
    - Significant payments to foreign-related entities
      - 3% of all deductions (2% for banks)
  - Tax is calculated on a tax base determined without regard to certain otherwise deductible amounts paid to foreign-related entities.

Rates/Years	2018	2019-2025	2026 -
Corporations	5%	10%	12.5%
Banks	6%	11%	13.5%

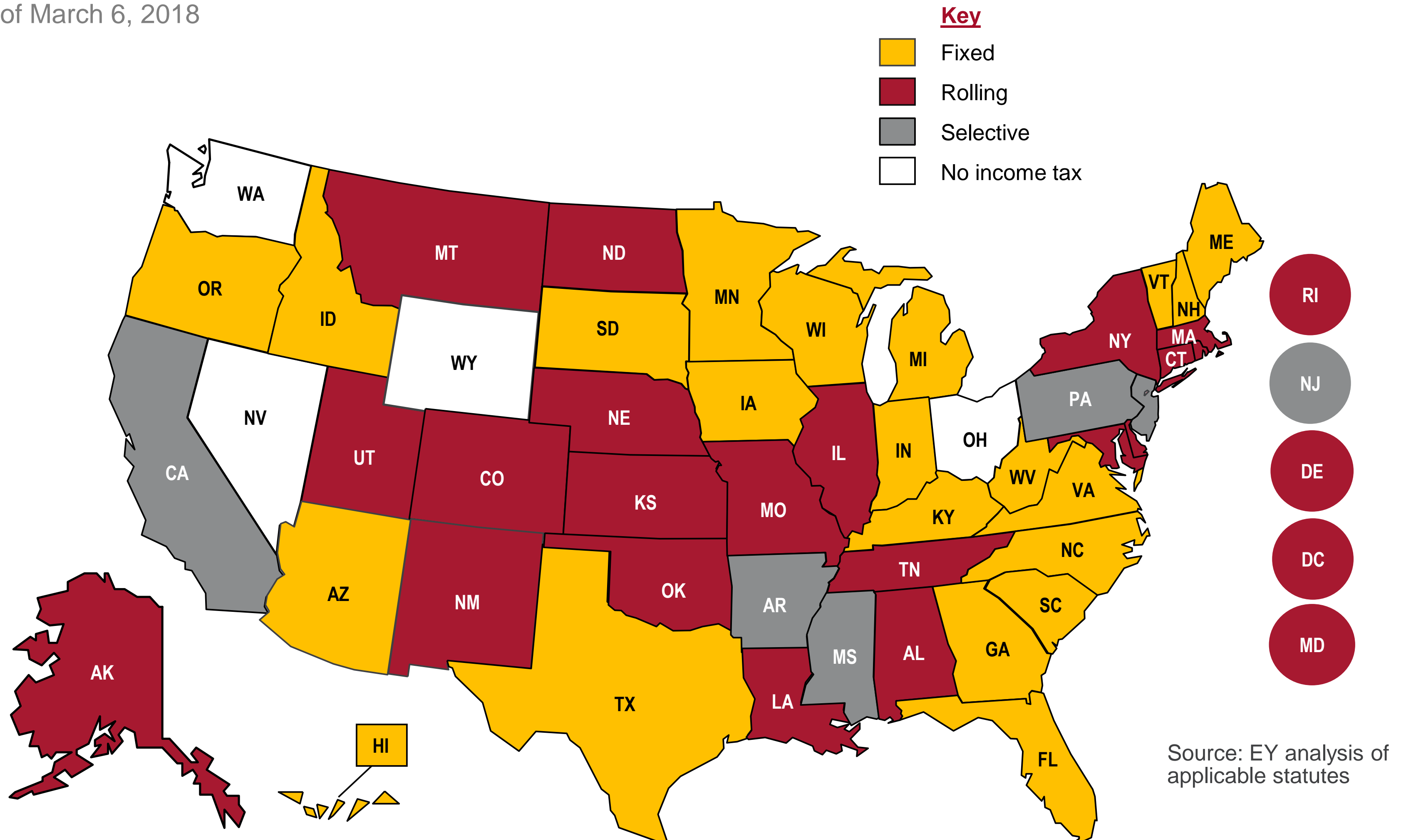
– **Related IRC Provisions**
  - IRC §59A (new) provides the new tax
    - Not part of calculation of federal gross or taxable income
    - Not part of state tax base

Potential State Impact of International Tax Reform Provisions

Federal	States
100% DRD of foreign dividends	Most states have their own DRDs – typically exempting 100% of dividends
Transition tax on “deemed” repatriated earnings	One-third of states tax some portion of Subpart F income and/or foreign dividends (typically 25% or less)
Tax on global intangible low-taxed income (GILTI) earned by CFC	Mostly state conformity (but constitutional limitations)
Deduction of 50% of GILTI income	Mostly state conformity (but “Line 28” state linkage issues)
Reduced tax on foreign-derived intangible income (FDII) of U.S. corporation	Mostly state conformity (but “Line 28” state linkage issues)
Base erosion anti-avoidance tax (BEAT)	Separate tax with no state conformity
Longer amortization schedule for foreign research and experimentation (15 years)	Likely state conformity (but constitutional issues)

State income tax conformity to IRC

As of March 6, 2018



Source: EY analysis of applicable statutes

Note – MI IRC conformity is January 2018 or if elected by Taxpayer Current Year (i.e. Rolling)

Note - CA & MA personal income tax law differs in its conformity to the IRC compared to CA & MA corporate tax law.

Note - OH doesn't have a corporate income tax. Personal income tax IRC adoption is Fixed

Pre-TCJA State Taxation of Foreign Source Income

- States generally did not follow federal “worldwide income” tax regime
- Both separate entity and combined return filing states generally limited taxation to the “water’s edge”
- Exceptions in some states:
  - Non-mandatory worldwide reporting
  - 80-20 companies
  - Tax haven provisions
  - Related party add back statutes
  - Partial taxation of foreign dividends

Conformity with TCJA International Tax Provisions: Center on Budget & Policy Priorities (CBPP) Perspective

Corporate use of international tax havens is widespread (CBPP perspective)

Some examples from Oregon. In most recent SEC 10-Ks:

- Nike reported 39 subsidiaries in the Netherlands, 3 in Singapore, and 1 each in Bermuda and Switzerland.
- Intel Corporation reported 7 subsidiaries in the Cayman Islands and 3 in the Netherlands.
- Columbia Sportswear reported 5 in Switzerland, 2 in Luxembourg, and 1 in the Netherlands.
- Precision Castparts reported 3 each in Luxembourg and Singapore, 2 each in the Caymans and Ireland, and 1 in Bermuda.
- "NIKE Asia Holding B.V." is incorporated in the Netherlands; "Intel Ireland Limited" is incorporated in the Cayman Islands.

International income shifting is a serious problem (CBPP perspective)

– Economist Kimberly Clausing – a leading expert – has estimated that these are the countries to which the largest amounts of (all nations') corporate profits have been artificially shifted

Table 1. Key Locations of Profit Shifting, 2012

Country	Gross Income Reported (billions)	Estimate of Gross Income Without Shifting (billions)	Percent of Total Excess Income in Location
Netherlands	$172.3	$33	23%
Ireland	$122.3	$23.6	16.3%
Luxembourg	$96.11	$15	13.4%
Bermuda	$79.7	$9.9	11.5%
Switzerland	$57.9	$14.6	7.2%
Singapore	$42.4	$10.5	5.3%
U.K. (Caymans)	$40.9	$8.7	5.3%

State conformity to TCJA international provisions (CBPP perspective)

- CBPP agrees with Tax Foundation (!) that "Oregon Should Conform to the Federal International Provisions under the Tax Cut and Jobs Act" because "[t]hese three provisions at the federal level work to limit base erosion and profit shifting among multinational companies and their affiliates."

  (although we disagreed that "with the inclusion of the BEAT, GILTI, and FDII, Oregon's tax haven law is unnecessary.")

- Indeed, all states should conform. But:
  - State policymakers should be aware that business community is poised to challenge state conformity -- in legislative chambers and courts.

Business opposition to state conformity to TCJA international provisions (CBPP perspective)

– COST:

"[T]he new taxation of foreign source income and related provisions is intended to shift the U.S. tax laws toward favoring domestic commerce over foreign commerce. While this may be a permissible goal for the federal government, states are limited by constitutional provisions such as the Foreign Commerce Clause that make it impermissible to favor domestic commerce over foreign commerce. Thus, while conformity to GILTI provisions may represent a modest short-term revenue boost (selective tax increase), this revenue will be subject to extensive litigation and may need to be refunded to taxpayers at a later date. In the meantime, taxpayer planning and complexity of administration will distort business decisions and unduly burden the [Georgia] State Department of Revenue." [Emphasis added]

Business opposition to state conformity to TCJA international provisions (CBPP perspective)

– McDermott Will & Emery:

“Base Erosion Alternative Minimum Tax [BEAT]

States may attempt to enact a similar alternative minimum tax. Focus would be on demonstrating the unconstitutionality of any such provision.” [Emphasis added]

Business opposition to state conformity to TCJA international provisions (CBPP perspective)

– Eversheds Sutherland:

“States implementing the mechanics of the Transition Tax [on ‘deemed dividends’] should be cognizant of the restrictions announced in *Kraft General Foods, Inc. v. Iowa Department of Revenue. . .* In *Kraft*, the US Supreme Court found that Iowa’s inclusion of dividends from foreign subsidiaries, but not from domestic subsidiaries, in a taxpayer’s apportionable income tax base unconstitutionally discriminated against foreign commerce. . . Because the Transition Tax requires an inclusion with respect to foreign subsidiaries while there is not a similar income inclusion with respect to domestic subsidiaries, a state’s conformity to the Transition Tax will likely face constitutional scrutiny under *Kraft*.

Additionally, taxpayers may argue that the Transition Tax is unconstitutionally discriminatory because states would include in taxable income a form of foreign (deemed) dividends (*i.e.*, subpart F income under IRC § 965), but not include the corresponding apportionment factors of the SFC.” [Emphasis added]

State response (CBPP perspective)

- States conforming to TCJA international provisions can reasonably anticipate legal challenges taking years to resolve

Accordingly:

- States should not build revenue from conformity into budgets
- States should not cut taxes in anticipation of an offsetting revenue “windfall” from conformity
- Until their legal authority to conform to TCJA international provisions is firmly established and those provisions are shown to be effective, states should not repeal other tax policies aimed at mitigating interstate and international income shifting, such as mandatory inclusion of tax haven subsidiaries in combined reporting or intangible expense addback requirements

Time for states to go their own way on international income-shifting: back to worldwide combined reporting (WWCR) (CBPP perspective)

- International provisions of TCJA both extremely complex and highly arbitrary
- Many experts dispute how effective they will be
- Do not mesh well with state corporate income taxes (CITs)
- Even if state constitutional authority to conform eventually upheld, likely to be many audit and court disputes about mechanics and state law issues in specific cases (e.g., is GILTI apportionable or non-apportionable?)
- Worldwide combined reporting most effective means of nullifying international income shifting in state toolkit; constitutionality established for both U.S.- and foreign-parent corporations
- If states aren't prepared to mandate WWCR, they should encourage its use by conforming to all TCJA international provisions and then allowing alternative WWCR election

Conformity with TCJA International Tax Provisions: Business Perspective

Conformity with International Tax Provisions (Business Perspective)

- The TCJA resulted in a federal tax cut for corporations, but according to EY's study will result in an **average state corporate tax base increase of about 12%** (based on 2018 update and pre-federal tax reform (FTR) linkage to IRC).
- This outcome is entirely **inadvertent**: If states conform mechanically to the TCJA, they will link to federal corporate base-broadening measures but not to federal corporate tax cuts.
- This outcome is arbitrary and inconsistent with the goals of FTR.
- **If states** want to conform to the revenue raising (international tax) provisions of corporate tax reform **they should also consider offsetting corporate tax rate cuts as well.**

Conformity with International Tax Provisions (Business Perspective) (cont'd)

- There is no clear evidence that profit shifting is eroding the state tax base. Businesses have paid about 45% of all state and local taxes…consistently over the last 20 years…the same years that base erosion and profit shifting has purportedly resulted in state tax revenue loss.
- States have not generally conformed in the past to the federal taxation of foreign source income earned by corporations, so why should they start doing so now?
- States should limit their tax regimes to the "waters' edge" as they have consistently done over the last 30 years.
- Taxation of foreign source income (without taxing similar types of domestic source income) is unconstitutional under the Commerce Clause and the *Kraft* case precedent.

Conformity with International Tax Provisions (Business Perspective) (cont'd)

- Mandatory worldwide combined reporting was bad tax policy in the 1980s when all states moved away from this approach; and it is still bad state tax policy today.
  - No other country in the world uses worldwide combined reporting.
  - U.S. trading partners (e.g., Canada, U.K.) in treaty protocols even call out for U.S. to eliminate it.
- If states do decide to conform to some of the TCJA international tax provisions, they should also:
  - Adopt other related IRC provisions such as Section 250 deductions
  - Provide apportionment "factor relief"
  - Delink from redundant provisions such as state corporate addback statutes or tax haven legislation.