State implications of federal tax reform – the international provisions
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Panel topics

► The shift to quasi-territorial federal taxation under the Tax Cuts and Jobs Act of 2017 (TCJA)

► Overview of state taxation of foreign income

► Key international provisions of the TCJA:
  ► Transition tax (Section* 965)
  ► Foreign dividends received deduction (Section 245A)
  ► Global intangible low-taxed income (GILTI) inclusion (Section 951A)
  ► Deduction for foreign-derived intangible income (FDII) and GILTI (Section 250)
  ► Other notable provisions and considerations

* “Section” references are to the Internal Revenue Code.
The shift to quasi-territorial federal taxation under the TCJA
The shift to quasi-territorial federal taxation under the TCJA

Pre-TCJA (worldwide)
- Worldwide tax base
- Plus/minus:
  - Foreign tax credit
  - Anti-deferral mechanisms (e.g., Subpart F regime)

Post-TCJA (quasi-territorial)
- Quasi-territorial tax base
- Plus:
  - Anti-deferral mechanisms (e.g., Subpart F regime, including GILTI provisions)
  - Anti-base erosion mechanism (e.g., base erosion and anti-abuse tax (BEAT))
Overview of state taxation of foreign income
Overview of state taxation of foreign income

► Conformity to the Internal Revenue Code (IRC) is key:
  ► Which states will conform?
  ► When will they conform?
  ► How will they conform?
► Even where general conformity applies, states have a history of decoupling from certain international provisions of the IRC:
  ► Sometimes decoupling is due to case law, nexus considerations, state tax haven rules, combined reporting implications or apportionment issues (including the unitary business theory).
► Regardless of **general** state conformity, don’t forget that states just can’t simply conform to the federal treatment of certain foreign-source income:
  ► Under the US Constitution, states are subject to restrictions on the taxation of foreign-source income that don’t apply to the federal government.
The "Constitution, and the Laws of the United States … made in pursuance thereof … shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding."

— US Const. art. VI
US Constitutional limitations on state taxation of foreign income

- The US Constitution is the “law of the land”:
  - It prevails over both federal laws and treaties, as well as state and local laws.
  - From a state tax perspective, the US Constitution can be thought of as a “tax treaty” among the states.
  - State and local tax is a lot like international tax, but it’s all in English!

- The Commerce Clause of the US Constitution (and the so-called dormant Commerce Clause) is a key provision impacting the state taxation of foreign income:

- Other clauses may apply:
  - Due Process Clause, Import-Export Clause, Equal Protection Clause, etc.
Key international provisions of the TCJA
Transition tax (Section 965)

Federal provision
► One-time “transition tax” for US shareholder on post-1986 deferred foreign income of a “specified foreign corporation” (i.e., a controlled foreign corporation (CFC) or any foreign corporation with at least one 10%-or-greater domestic corporate shareholder):
  ► 15.5% rate on cash and cash equivalents and 8% rate on the remainder

Key state implications
► The “Day 1” issue:
  ► Driven by state’s treatment of Subpart F (subpart F?) income and foreign dividends (also are deemed dividends the same as actual dividends?)
  ► Most states allow a full or partial deduction for Subpart F income (and foreign dividends) from their tax base:
    ► Recall Kraft (see, however, Appeal of Morton Thiokol, Inc. (Kansas, 1993) and E. I. Du Pont de Nemours & Co. (Maine, 1996))
  ► States that exclude Section 965(a) income (in whole or in part) may disallow expenses attributable to non-taxable income.
  ► States may decouple from the Section 965(c) deduction:
    ► If not, is “double-dipping” possible under state statute?
    ► Consider the impact on apportionment factors and the ability to qualify for special state elections or qualifications.
    ► In nonconforming states, consider the necessity of state-only Subpart F income recomputations in future tax years.
    ► Consider the impact of recent reporting guidance issued by the Internal Revenue Service.
Foreign dividends received deduction (Section 245A)

Federal provision
► Domestic corporations allowed a 100% deduction for the foreign-source portion of dividends received from specified 10%-or-greater owned (vote or value) foreign corporations (deduction not available for capital gains or directly earned foreign income).

Key state implications
► The “Day 2” issue:
  ► Future foreign dividends, and even future actual distributions that are excluded from federal taxable income under the federal previously taxed income (PTI) regime (Section 959), may be taxable in certain states (notably, California):
    ► Disparate state analysis for distributions from pre-2018 E&P (earnings and profits) versus post-2017 E&P
  ► States that exclude foreign dividend income may disallow expenses attributable to nontaxable income.
  ► Consider sources of state’s previously taxed income.
  ► Special state apportionment factor methodologies may apply to foreign dividend income (e.g., New Mexico, Vermont).
GILTI inclusion (Section 951A)

Federal provision
► Mandatory annual inclusion of GILTI determined on an aggregate US shareholder basis for all CFCs; partial credits for foreign taxes properly attributable to the GILTI inclusion
► Qualified business asset investment (QBAI) reduction
► Section 78 GILTI basket?

Key state implications
► How a state treats GILTI may not necessarily depend solely on how the state treats existing Subpart F income under Section 951(a):

- GILTI ≠
- Section 951(a) inclusion or
- Section 952 Subpart F income or
- Deemed distribution from E&P

► Determining the state treatment requires careful analysis of state statutory conformity to the federal determination of taxable income and presumably the Subpart F regime.
► How the GILTI inclusion will be reported on the federal income tax return could impact the resulting state income tax treatment in some states.
► Raises questions as to how GILTI will be treated for apportionment factor representation purposes:
  ► Will the state include the CFC's factors attributable to such income?
Deduction for FDII and GILTI (Section 250)

Federal provision
► Domestic corporations allowed a deduction against:
  ► FDII (37.5% deduction initially, reduced to 21.875% for tax years beginning after 2025)
  ► Mandatory GILTI inclusion (50% deduction initially, reduced to 37.5% for tax years beginning after 2025)
► Taxable income limitation

Key state implications
► How this new deduction will be reported on the federal income tax return could impact the resulting state income tax treatment in some states:
  ► Section 250 is included in Part VIII of Subchapter B of Chapter 1 of Subtitle A of the IRC, which houses many (but arguably not necessarily all) “special deductions”:
    ► Consider the impact in certain “Line 28 states”
    ► Is it possible that the new deduction might be split between FDII and the GILTI inclusion and reflected in separate areas of the federal income tax return, perhaps even above Line 28?
► States may legislatively decouple from all or a component of Section 250 (e.g., New York):
  ► States may find that the new deduction amount does not correspond to the state’s effective tax rate, and they may want to address this disparity.
  ► Might the taxable income limitation operate differently?
Other notable provisions and considerations

► Other notable TCJA international provisions:
  ► BEAT (Section 59A)
  ► Hybrid arrangements and hybrid entities (Section 267A)
  ► Business interest expense limitation (Section 163(j))

► Other interactions with state tax base rules:
  ► Filing methodology (worldwide vs. water’s-edge vs. separate)
  ► “80/20” rules
  ► Tax haven rules
  ► Related-party expense add-back rules
  ► Unitary vs. non-unitary income
  ► Business vs. non-business income
Thank you!
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