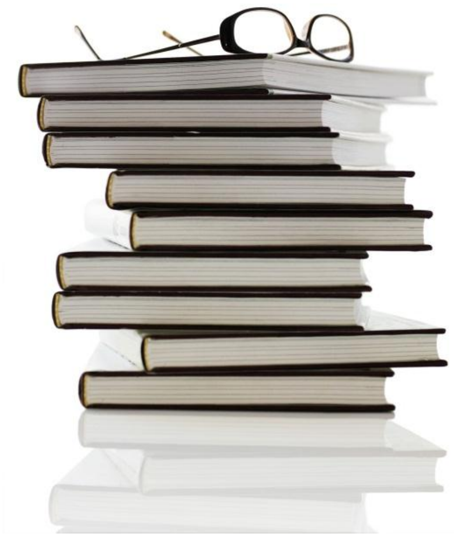
State Tax Implications of International Operations



Charles Fischer, Deloitte Tax LLP

December 6, 2012

Tax Executives Institute – Detroit

Agenda

- Federal overview
- State modifications related to foreign source income
- Differences between federal and state “80/20” companies
- State considerations for foreign entities
- Coordination with international tax planning
- Examples of typical international corporate structures

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Federal overview

Key federal income tax concepts

- Worldwide vs. territorial regime
- Tax treaties
- Permanent establishment ("PE")
- U.S. trade or business
- Effectively connected income ("ECI")
- Fixed or determinable, annual or periodic ("FDAP") income

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Federal taxation of U.S. owned foreign subsidiaries

- Controlled foreign corporation (“CFC”)
  - Incorporated in foreign country and greater than 50% ownership by vote or value, directly or indirectly, by U.S. shareholders
- Check-the-box entities and hybrid branch structures
  - Due to elections or differences in law between jurisdictions, the status of an entity can vary between the U.S. and foreign taxing jurisdiction
- Income is generally deferred from U.S. tax until distributed to the U.S. shareholder
  - One exception is Subpart F income, which is taxed currently in the U.S.
- Dividends from foreign subsidiaries received by U.S. shareholders are subject to U.S. tax
- If the stock of a 10% or more owned foreign subsidiary is sold, the U.S. may tax the undistributed foreign earnings (i.e., foreign E&P) of the subsidiary as a dividend rather than as a gain on the sale of stock (i.e., IRC § 1248 dividends)

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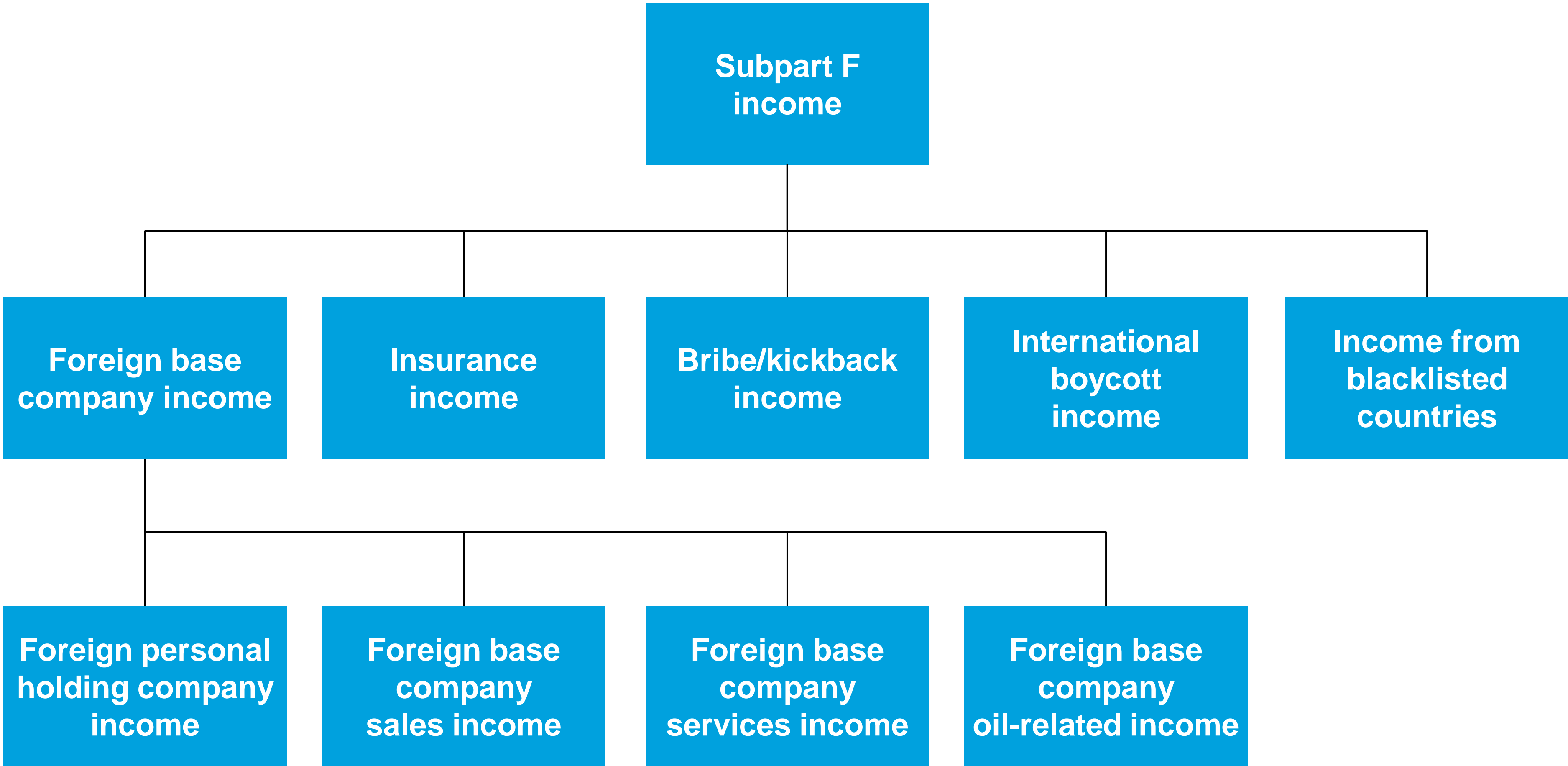
Overview of Subpart F income



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State modifications related to foreign source income

State modifications related to foreign source income

- Various state subtraction modifications may be available to U.S. companies with respect to their foreign source income (specifics will vary by state)
  - Exclusion of all foreign source income
  - DRD or other subtraction provisions for foreign dividend income, including deemed dividends such as IRC § 78 Gross-Up, Subpart F income, and IRC § 1248 dividends
    - Not all states conform to the federal classification of certain “deemed” dividend income
      - For example, CA does not recognize Subpart F income, but rather recognizes the dividends from CFC’s when actually distributed.
      - CA also does not conform to IRS § 1248, so for CA purposes, such income is recognized as gain on the sale of stock
  - Exclusion of foreign royalty income
  - Deduction for foreign taxes that were not deducted federally as a result of claiming the foreign tax credit

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Differences between federal and state “80/20” companies

Differences between federal and state "80/20" companies

- The concept of an "80/20" company for federal purposes was based on at least 80% of a U.S. corporation's gross income from all sources for a three year testing period being active foreign business income
  - The federal "80/20" rules were set forth in IRC § 861(c), but 2010 legislation repealed those rules for tax years beginning in 2011 (subject to certain grandfathering provisions)
- The state concept of an "80/20" company is different and is most often linked to the average of a U.S. corporation's property and payroll factors
  - 9 states look at average property and payroll (CO, IL, IN, MT, NH, ND, TX, UT, and VT)
    - In TX, if there is no property and payroll, then sales are used
  - 2 states look at average property, payroll, and sales (AZ and AK, with AK also utilizing an active foreign business income test)
  - 3 states utilize the federal active foreign business income test (MI, MN, and WI)

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Differences between federal and state "80/20" companies

- For states with "80/20" company provisions, eligible "80/20" companies are generally excluded from unitary combined returns; however, in some states, a portion of the "80/20" company's income may be included in the combined return
  - In MN and MT, the income of an "80/20" company is treated as a deemed dividend and subject to an 80% DRD
  - In ND, 30% of the net book income of the "80/20" company is included in the combined return
  - In UT, an "80/20" company is included in the combined return but 50% of its income is excluded
  - In WI, an "80/20" company may still be included in the combined return to the extent of its taxable U.S. source income

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State considerations for foreign entities

State considerations for foreign entities

- Federal conformity
  - Entity classification
  - Taxable income
  - Impact of tax treaties
- State nexus
  - PE is a term of art used in bilateral tax treaties, and its definition may vary
  - A foreign entity may have nexus for state tax purposes, yet lack a PE with the U.S.
  - PE generally requires a fixed place of business, while state nexus can exist without a fixed place of business in the state, and may even exist without any physical presence in states that adopt an economic or factor presence nexus standard
  - Public Law 86-272 protection does not explicitly apply to foreign commerce

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State considerations for foreign entities

- Foreign entity inclusion in unitary combined reports
  - Worldwide filings
  - Water's edge filings
    - 20% or more U.S. factors
    - Subject to federal income tax or required to file federal income tax return
    - Effectively connected income
    - U.S. source FDAP income
    - Subpart F income inclusion ratio
    - More than 20% of income from related party intangible property or services
    - Tax havens
- Related party expense addback rules
  - Many states, including a number of unitary states, require the addback of related party expenses (e.g., interest, intangible fees, management fees)
  - Payments to foreign affiliates may be subject to addback; however, addback exceptions vary by state, but many include an exception for payments to a foreign affiliate taxed in a country with a U.S. income tax treaty

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State considerations for foreign entities

- Market-based sourcing of services
  - Growing number of states are adopting market-based sourcing rules for services (as well as intangibles)
  - Be careful of market-based sourcing when determining whether a foreign entity has U.S. factors of 20% or more
- Non-income based taxes
  - Even if not subject to income based taxes, is the foreign affiliate subject to any other state taxes?
    - Franchise/net worth taxes
    - Gross receipt taxes
    - Sales/use taxes
  - Typically, lower nexus thresholds may exist

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State implications of tax treaties

State implications of tax treaties

- U.S. tax treaties are not specifically binding on the states
  - Some states may explicitly adopt the treaty provisions; however, even when a state explicitly provides that income that is exempt from federal income tax pursuant to a tax treaty is also exempt for state tax purposes, you must closely examine the nature of that conformity
    - For example, MA will conform to treaty provisions to the extent the treaty exempts or sources income so that it is not subject to federal taxation; however, when a treaty simply reduces the rate of taxation on income (such as lowering the withholding rate), such income may be fully includible for state tax purposes
- Most states start with federal taxable income as the starting point for computing state taxable income
  - Federal taxable income takes into account the concept of PE where a treaty applies and ECI related to a U.S. trade or business
  - Without a modification, foreign corporations with no federal taxable income reported on Form 1120F may have no state taxable income (but may have minimum tax obligations or be subject to non-income based taxes)
  - Without a modification, income reported on Form 1120F is generally limited to income earned in the U.S., not worldwide income

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State implications of tax treaties

- Some states (e.g., NJ, NY, and OR) require worldwide income computations without regard to limitations on taxable income under the IRC or treaties
- Not all states are tied directly to federal taxable income, so in these states, even when there is no income for federal purposes, there may be “federal taxable income” for state tax purposes
  - For example, foreign corporations are subject to a net basis tax on ECI related to a U.S. trade or business; however, tax treaties often require a PE in order for income to be considered ECI, but if the treaty provisions are not binding for state purposes (either explicitly or implicitly), the entity may have ECI for state tax purposes (e.g., AL, AR, CA, HI, MS, MT, PA, and WV)

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Coordination with international tax planning

International tax planning considerations

- International tax ("IT") planning may impact state taxes
  - Where IT planning results in federal taxable income, the state tax consequences may be different
  - Even where IT planning does not result in federal taxable income, unexpected state tax consequences may exist
- IT planning may involve a foreign corporation that is required to have a minimal presence in the U.S. under the tax rules of a foreign country
  - Presence may be insufficient to create a PE and may not result in any federal taxable income due to treaty provisions; however, in various states, federal limitations on income under the IRC or treaty provisions may not apply (e.g., AL, AR, CA, HI, MS, MT, NJ, NY, OR, PA, and WV)
- IT planning may involve foreign entities that are disregarded for federal income tax purposes
  - Most states follow federal disregarded treatment; however, NH and TX do not follow the federal disregarded entity rules and MN does not permit foreign "entities" to be included in its combined return, so in these states, the foreign entities are regarded for state tax purposes
- IT planning often involves holding companies that have minimal operations and file mostly in combined return states, and perhaps, in the group's state of commercial domicile

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Federal consolidated return rules (CRR's)

- IT planning may rely on the CRR's to avoid federal tax issues
  - Generally, none of the separate return states adopt the CRR's
  - Some combined states adopt essentially all the CRR's
  - Some combined states adopt some of the CRR's
    - Usually the deferred intercompany transaction rules under Reg. § 1.1502-13 and occasionally some of the other rules
    - States that do not adopt the deferred intercompany transaction rules under Reg. § 1.1502-13 provide for the "elimination" of intercompany transactions, but the exact tax consequences may be different
  - Some combined states adopt none of the CRR's
- Some provisions of the CRR's that can impact the state tax liability if they are not applicable include:
  - Investment adjustments to stock basis under Reg. § 1.1502-32
  - Reg. § 1.1502-80, which turns off IRC § 304 for acquisitions of stock in intercompany transactions and IRC § 357(c) gain in intercompany transactions
  - Reg. § 1.1502-90 through 99 dealing with the application of IRC § 382
  - Reg. § 1.1502-34 aggregates ownership of subsidiary by members of the group for purposes of meeting the 80% ownership test in IRC § 332 and § 351

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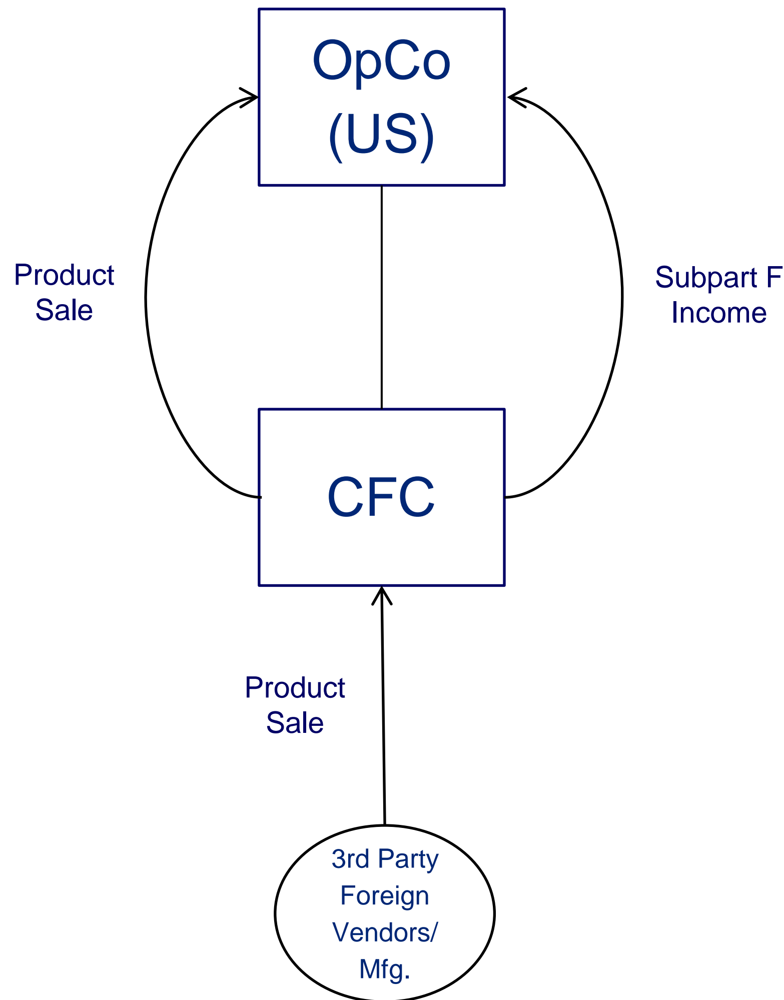
Examples of typical international corporate structures

Foreign sourcing/procurement – Buy/sell



- CFC purchases raw materials and/or finished goods from foreign vendors or manufacturers and resells to OpCo
- Products shipped directly to OpCo from foreign vendors or manufacturers
- CFC income may be Subpart F income as foreign base company sales income
- Depending on the nature of the foreign procurement function and which country the goods are procured from, some or all of the CFC's income may not be Subpart F income; therefore, not subject to current taxation for federal income tax purposes

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State tax considerations

- Will OpCo's Subpart F income be subject to state income tax?
- Does CFC have nexus in any states?
- Will CFC be included in any unitary combined returns?
- If CFC has state nexus and/or is included in any unitary combined returns, how is its income tax base and state apportionment determined?
  - Do U.S. tax treaty provisions apply?
- Could CFC be subject to any non-income based taxes?

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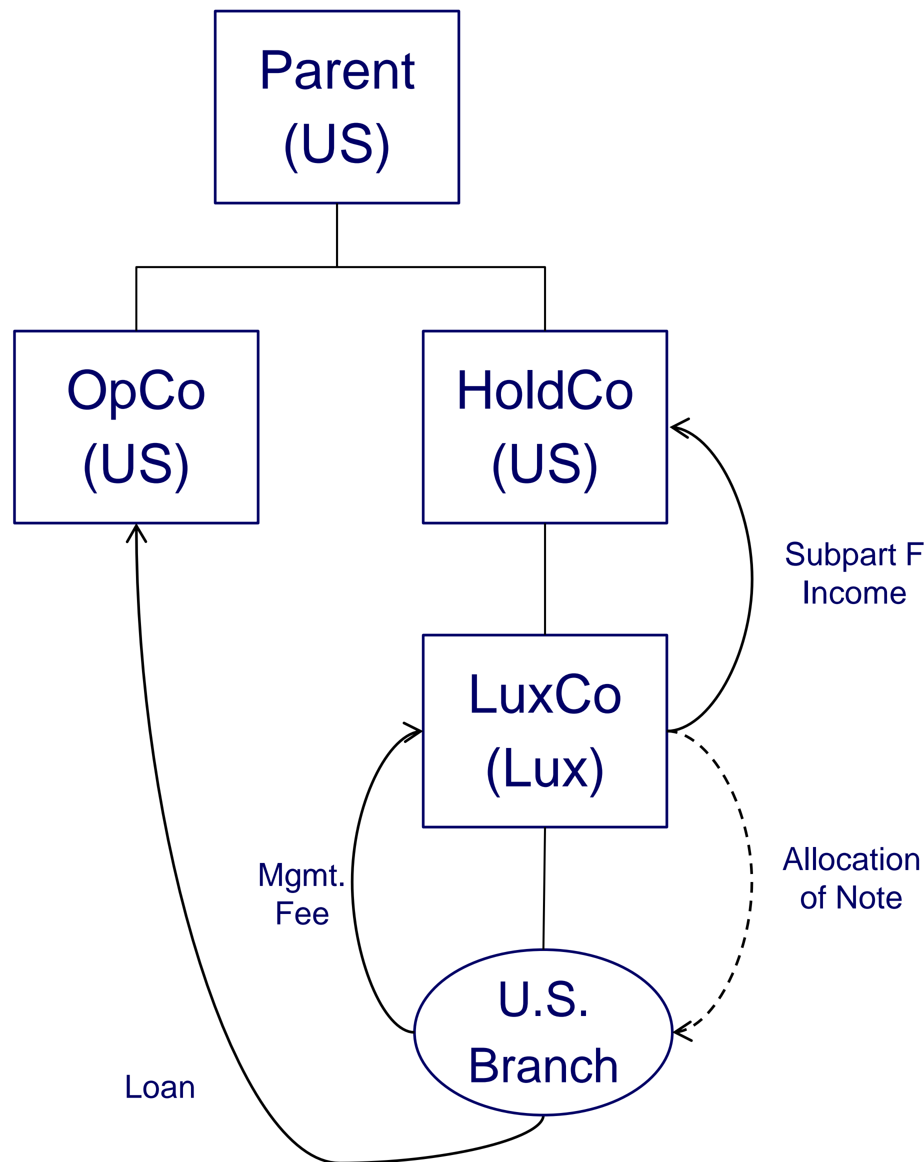
Intercompany lending from LuxCo with U.S. branch



- LuxCo holds an intercompany note from OpCo, which is allocated to its U.S. branch
- U.S. branch pays a management fee to LuxCo
- OpCo makes interest payments to LuxCo
- HoldCo recognizes Subpart F income to the extent of interest income earned by U.S. branch of LuxCo

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State tax considerations

- Will HoldCo's Subpart F income be subject to state income tax?
- Will OpCo's related party interest expense be subject to addback in any states, and if so, does it qualify for an addback exception (taking into consideration that related interest income is not subject to tax in Luxembourg)?
- Does LuxCo have nexus in any states, particularly in light of the activities of the U.S. branch?
- Will LuxCo be included in any unitary combined returns?
- If LuxCo has state nexus and/or is included in any unitary combined returns, how is its income tax base and state apportionment determined?
  - Do U.S. tax treaty provisions apply?
- Could LuxCo be subject to any non-income based taxes?

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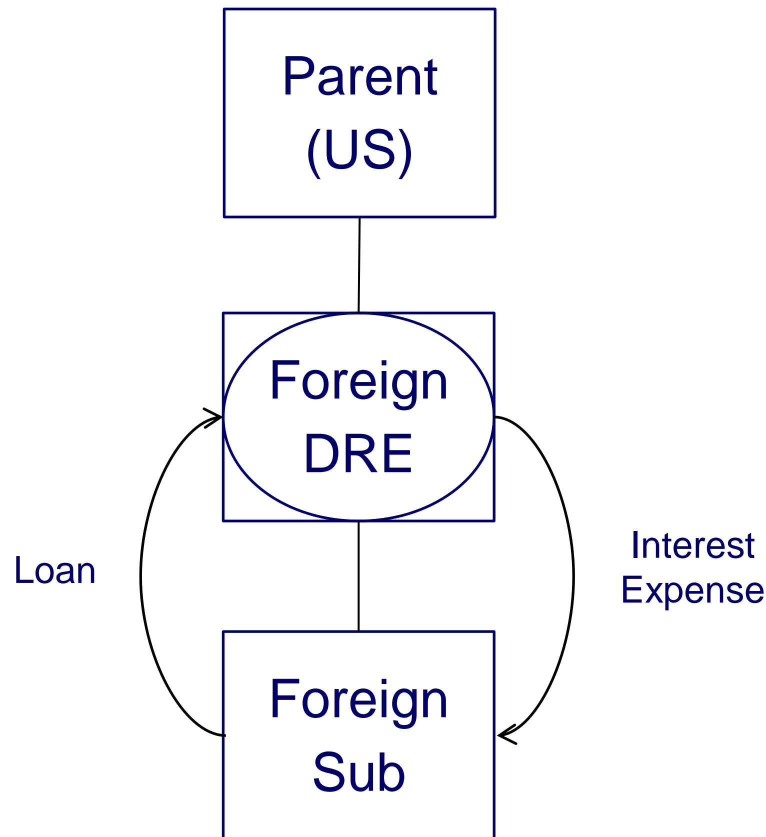
Intercompany lending from foreign disregarded entity



- Foreign DRE makes interest payments to Foreign Sub
- Foreign DRE is a disregarded entity for U.S. federal income tax purposes
- Parent recognizes interest expense deduction on payments made by Foreign DRE

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State tax considerations

- Will Foreign DRE be respected as a disregarded entity for state tax purposes?
- Will Parent's related party interest expense be subject to addback in any states, and if so, does it qualify for an addback exception?
- Does Foreign Sub have nexus in any states?
- Will Foreign DRE or Foreign Sub be included in any unitary combined returns?
- If Foreign Sub has state nexus and/or is included in any unitary combined returns, how is its income tax base and state apportionment determined?
  - Do U.S. tax treaty provisions apply?
- Could Foreign Sub be subject to any non-income based taxes?

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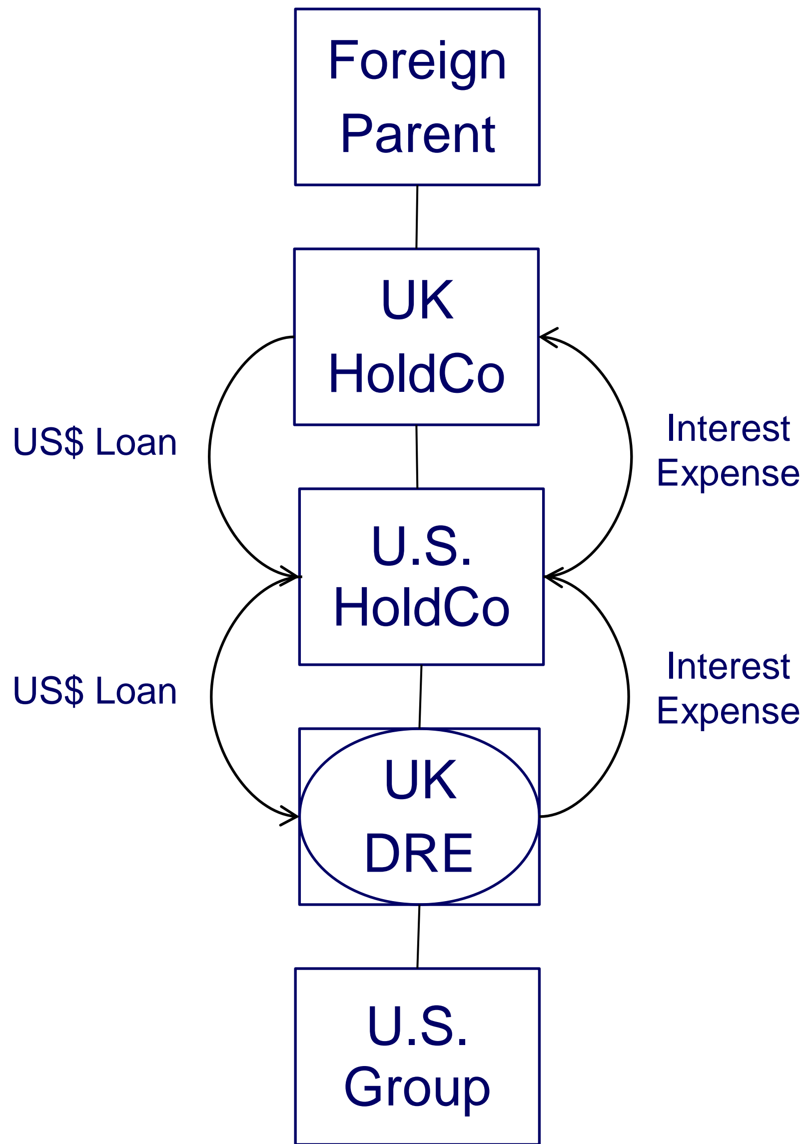
UK tower financing



- UK DRE is a disregarded entity for U.S. federal income tax purposes
- UK HoldCo loans funds to U.S. HoldCo, who in turn loans funds to UK DRE
- Loan between U.S. HoldCo and UK DRE is disregarded for U.S. federal income tax purposes
- UK Holdco interest income is offset by UK DRE interest expense under UK group relief provisions

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State tax considerations

- Will UK DRE be respected as a disregarded entity for state tax purposes?
- Will U.S. HoldCo's related party interest expense be subject to addback in any states, and if so, does it qualify for an addback exception?
- Will UK HoldCo have nexus in any states?
- Will UK HoldCo or UK DRE be included in any unitary combined returns?
- If UK HoldCo has state nexus and/or is included in any unitary combined returns, how is its income tax base and state apportionment determined?
  - Do U.S. tax treaty provisions apply?
- Could UK HoldCo be subject to any non-income based taxes?

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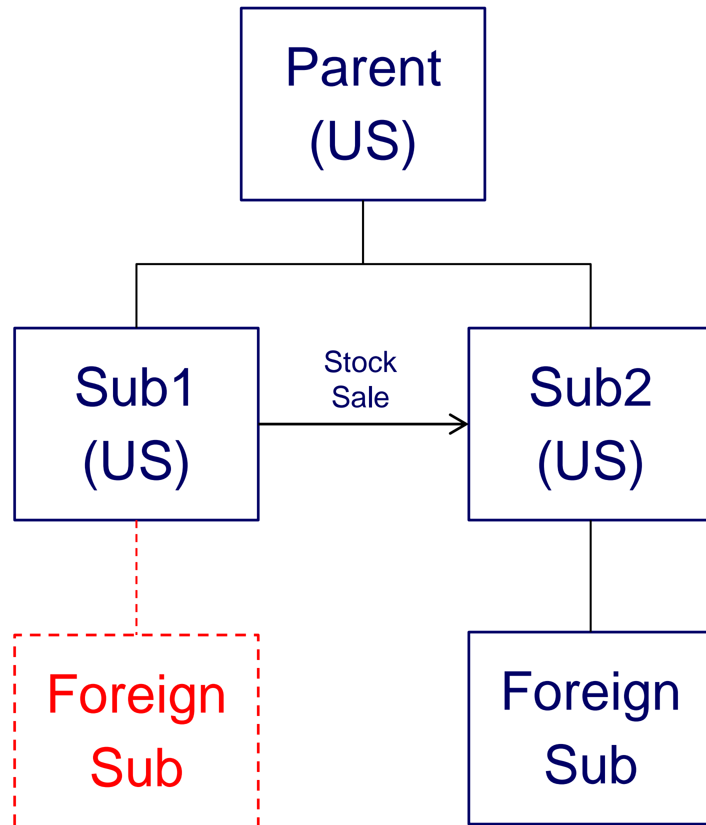
IRC § 304 transaction



- Sub1 sells stock of Foreign Sub to Sub2 in exchange for cash or a note
- IRC § 304 treats the sale of Foreign Sub stock as if Sub2 distributed cash to Parent in "redemption" of its own stock
- Under IRC § 304, the sale of Foreign Sub stock is treated as a dividend from Sub2 to Parent to the extent of Sub2 E&P, and if Sub2 does not have sufficient E&P, then there is also a distribution of Foreign Sub E&P to Parent
- IRC § 304 turned off by CRR's

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State tax considerations

- Does the state adopt IRC § 304?
- Will the state apply the CRR's and turn off IRC § 304?
- If IRC § 304 applies, will the dividend on the distribution of Foreign Sub E&P to Parent be subject to state income tax?

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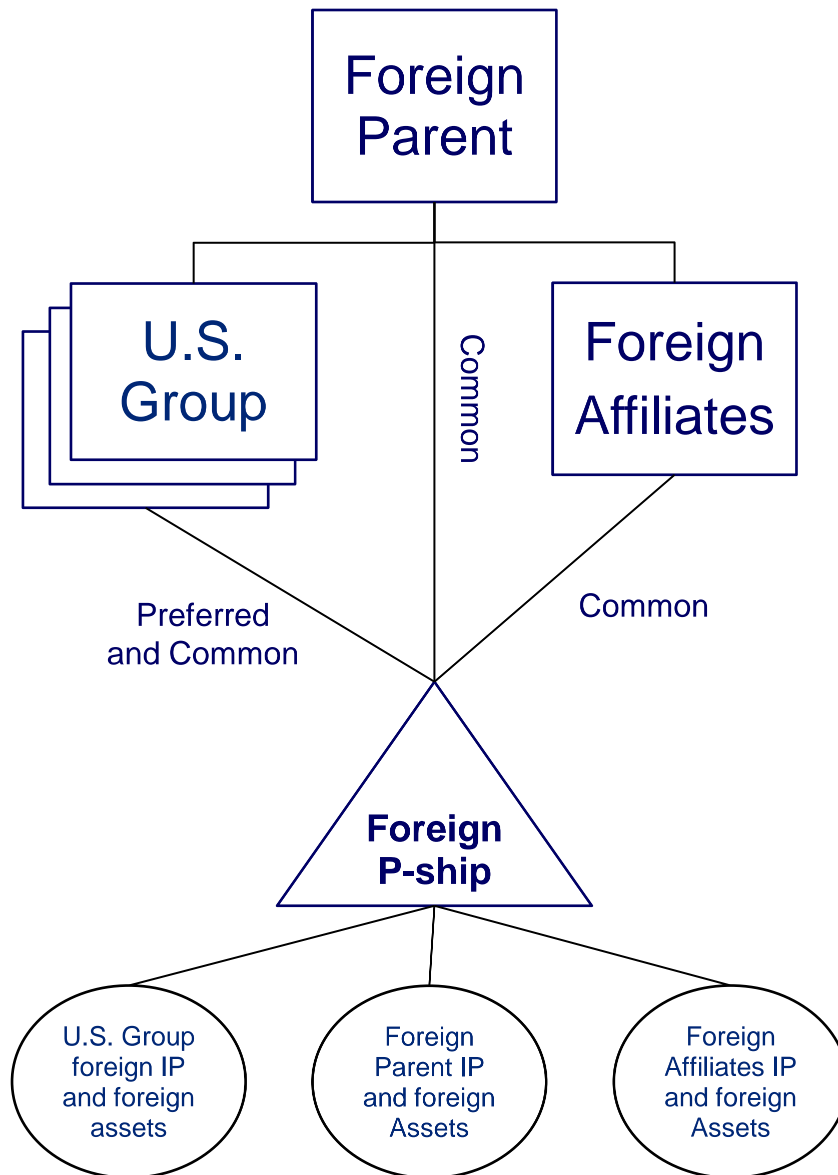
Foreign freeze



- Foreign Parent, Foreign Affiliates, and U.S. Group contribute foreign IP and/or certain foreign assets to Foreign P-ship
- Foreign Parent and Foreign Affiliates receive common interests in exchange for the asset contribution
- U.S. Group receives a fixed rate preferred interest and a common interest in exchange for asset contribution
- Foreign P-ship may be an entity treated as a corporation for local country purposes, but then treated as a partnership for U.S. federal income tax purposes under the check-the-box rules

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State tax considerations

- If Foreign P-ship is treated as a corporation for local country purposes but as a partnership for federal income tax purposes under the check-the-box rules, will Foreign P-ship be respected as a partnership for state tax purposes?
- How will the income attributable to the preferred and common interests be treated for state tax purposes?
- How will the Foreign P-ship apportionment factors be attributable to the preferred and common interests, and to what extent will the Foreign P-ship apportionment factors be included in state returns?
- Is the U.S. ownership of the Foreign P-ship held by a new or existing domestic, tax-efficient subsidiary, which could exclude the Foreign P-ship income from the state tax base in separate company filing states?
  - Could the new or existing domestic subsidiary qualify as a state 80/20 company?

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Contact information

Charles Fischer
Senior Manager, National Multistate Tax Services
St. Louis
Deloitte Tax LLP
314-641-4349
chafischer@deloitte.com

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