The Renewed Focus on Combined Reporting and Worldwide Income

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Agenda

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Filing Methods

Worldwide combined reporting

- Held constitutional in *Container* and *Barclays Bank*, but no state requires worldwide combined reporting without providing water's-edge election
  - Ability
  - Elective in certain states – e.g., D.C., Massachusetts, New Jersey, Utah, West Virginia
  - Potential

Water's-edge reporting

- Elective in two states – e.g., California, Idaho
- Default in most states – e.g., Illinois, Michigan, Minnesota, Wisconsin
- Some states exclude all foreign corporations from their unitary returns filed on a waters' edge basis; however, many states still include foreign corporations under certain circumstances

Filing Methods

- Water's-edge election generally excludes certain non-US affiliates, except:
  - Non-US members if average of property, payroll, and sales factor within US is 20% or more
  - US source income of non-US members without regard to treaties
  - Certain Subpart F income and GILTI of non-US members
  - Non-US members that earn more than 20% of income from intangible property or services related activities that are deductible by other members, to extent of income and apportionment factors
  - Entire income of member doing business in tax haven

Worldwide Reporting

- **Benefits of Worldwide Reporting:**
  - Intergroup eliminations
    - Actual dividend distributions
    - Subpart F income and GILTI
    - Section 367 transactions
  - Tax haven issues
  - Foreign entity income / apportionment dilution
- **Add-backs may make water's-edge group detrimental**
- **Issues with Worldwide Reporting:**
  - Functional currency
  - Accounting methods
  - Book v. tax records
  - International tax planning
  - Non-tax issues

Recent legislation - Elections

- New Jersey – Affiliated Group Election
  - Available for tax years ending on and after 7/31/2019
  - Binding for the tax year of the election, plus 5 subsequent tax years
- New York – Election for "commonly owned groups" with a seven-year election period
- Rhode Island – Election for an affiliated group of corporations regardless of whether the corporations are engaged in a unitary business with a 5-year election period
- Massachusetts and Wisconsin already allow a 10-year election to include all members in the affiliated group (using a greater than 50% ownership threshold)

Foreign Entity Inclusion

- Some typical rules for inclusion of foreign entities:
  - A foreign corporation may be included in a unitary return if it is subject to federal income tax or required to file a federal income tax return
  - A foreign corporation may also be included in a unitary return to the extent of its ECI
  - A foreign corporation with no ECI may be included in a unitary return to the extent of its U.S. source FDAP income

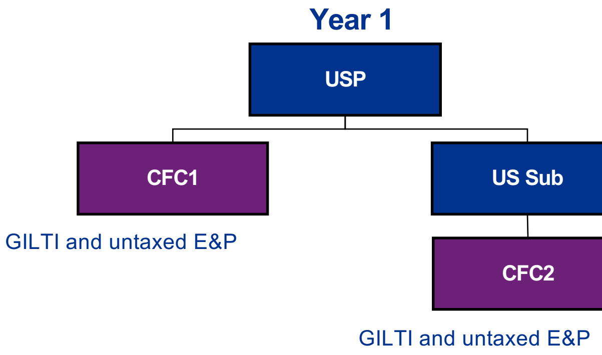
Foreign Entity Inclusion

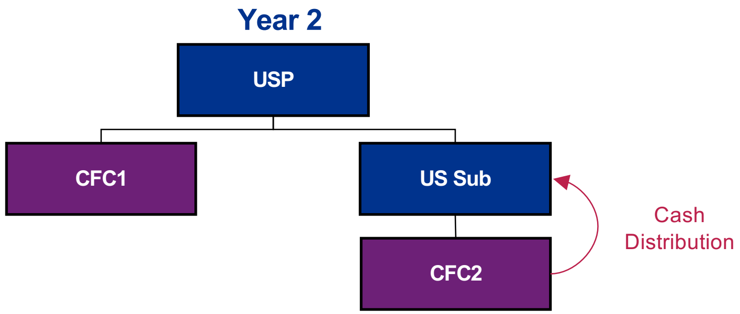
Some typical rules for inclusion of foreign entities (cont'd)

- A CFC may be included in a unitary return to the extent of its subpart F income and GILTI
  - In California, a CFC is included in the unitary return based on the ratio of its subpart F income to current year E&P
  - In West Virginia, the income of a CFC is included to the extent of its subpart F income, but any income that was subject to an effective rate of tax in a foreign country that is greater than 90% of the maximum federal rate is excluded (i.e., "high tax CFC exception")
  - Most states provide a full or partial deduction for GILTI and also conform to the federal GILTI and subpart F high-tax exceptions

New York – A non-US corporation's tax is computed on federal effectively connected income without regard to tax treaty benefits

CFC Inclusions and Dividends





Facts

- USP and US Sub are in same U.S. consolidated group
- In Year 1, CFC1 and CFC2 each earn GILTI tested income and exempt income.
- In Year 2, CFC2 distributes cash to US Sub.

Federal Tax Considerations

- Special rules apply for calculating GILTI inclusions for a consolidated group.
  - Aggregation approach (not exactly a single-entity approach, but similar principles apply)
- CFC2's distribution will be treated as coming:
  - First come from GILTI PTEP; and then
  - From untaxed E&P.
    - Distribution of untaxed E&P should generally be eligible for § 245A DRD.

State Tax Considerations

- GILTI calculation may need to be calculated on separate company basis
- In states that do not tax GILTI, there may be distributions of PTEP for federal but not for state purposes
- Certain states treat GILTI as a foreign dividend and allow a state DRD
- The inclusion of the GILTI receipts in the apportionment factor could result in factor dilution in some states, reducing the amount of tax due. Also consider Foreign Commerce Clause discrimination arguments.
- Distribution out of untaxed E&P eligible for § 245A deduction may not be fully deductible for state purposes (e.g., MN only allows an 80% DRD for foreign dividends)
- California does not adopt § 951A by virtue of conformity date and would not have GILTI PTEP
  - Possible elimination of Year 2 distribution if filing on worldwide basis
  - Possible 75% DRD for Year 2 distribution if filing on a water's-edge basis

Foreign Entity Inclusion

- A foreign corporation may be included in a unitary return to the extent that 20% or more of its activity is within the US
  - Some states will look at the average of the corporation's property and payroll factors
  - Other states look at the average of the corporation's property, payroll, and sales factors
  - Another approach is whether the corporation has less than 80% active foreign business income
  - Data and planning

Foreign Entity Inclusion

- California
  - Unique rules
- Michigan – foreign corps and foreign operating entities are excluded
  - Foreign Operating Entity: a U.S. corporation with substantial operations outside the U.S., and at least 80% of its income is active foreign business income as defined in IRC Sec. 861(c)(1)(B)

Foreign Entity Inclusion

- Rhode Island
  - Non-US corporations are excluded from the combined group if the sales factor of the non-US corporation outside the US is 80% or more
  - If the non-US corporation is includable, income subject to the provisions of a tax treaty and attributable expenses or apportionment factors are not includable in the determination of the combined group's net income
  - Special "tax haven" rules
- Texas
  - If 80% of a taxable entity's property and payroll is outside the U.S., the entity is excluded

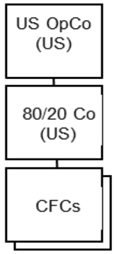
Foreign Entity Inclusion

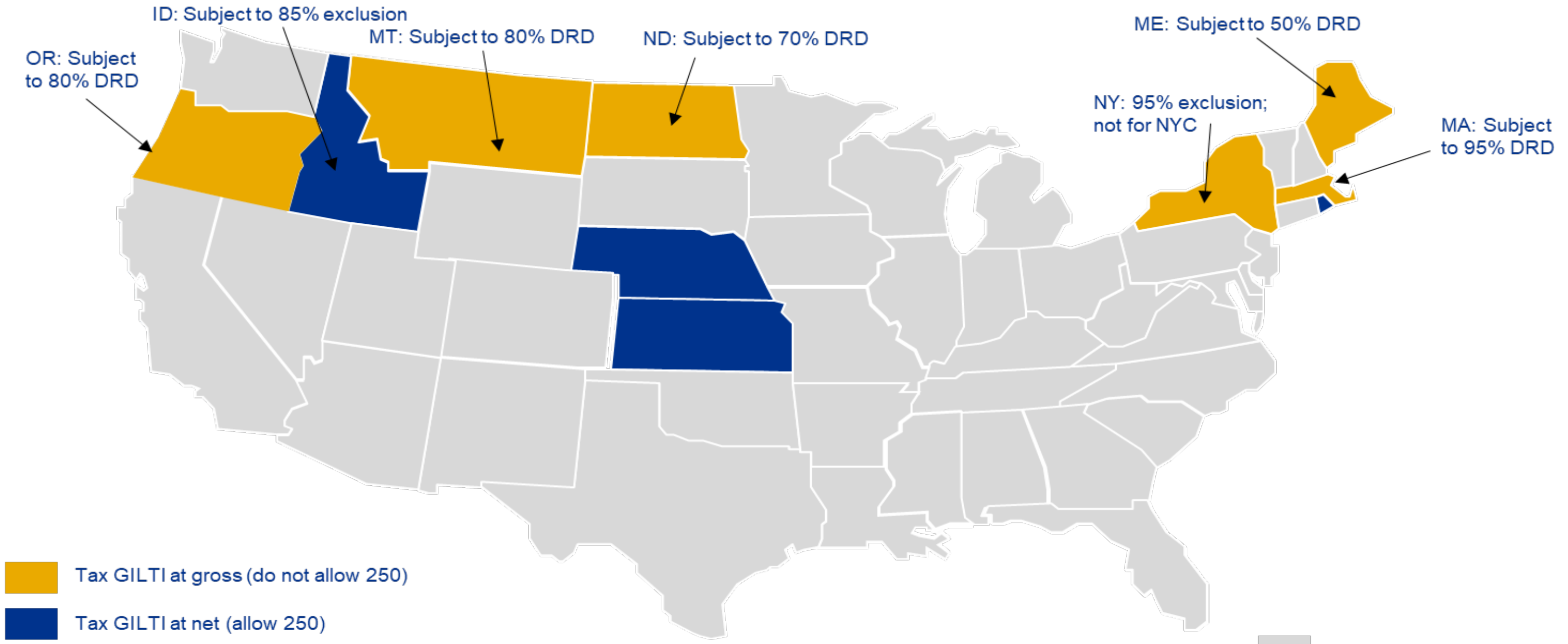
- Inclusion of a foreign corporation in a unitary return if it earns more than 20% of its income, directly or indirectly, from intangible property or service related activities, the costs of which are deductible against the business income of other members of the unitary group (DC, MA, NJ, and WV)
  - Inclusion is limited to the extent of the income and apportionment factors related to such intangible property and service related activities
  - In DC, the provision is limited to foreign corporations that are residents of a country that does not have a comprehensive income tax treaty with the U.S.
  - In WV, the provision does not apply to income that is exempt from federal income tax pursuant to a comprehensive income tax treaty with the U.S.

Domestic Entity Exclusion Under 80/20 Rules

- A domestic corporation may be excluded from a unitary return to the extent that 80% or more of its activity is outside the US
  - Some states will look at the average of the corporation's property and payroll factors
  - Other states look at the average of the corporation's property, payroll, and sales factors
  - Another approach is whether the corporation has more than 80% active foreign business income
- Data and planning

State taxation of GILTI in 2020 with 80/20 company structure





Tax GILTI at gross (do not allow 250)

Tax GILTI at net (allow 250)

(1) Does not tax GILTI either by decoupling or applying an 100% exclusion; in some cases 100% exclusion is ONLY assuming 100% ownership – i.e., IN, IL, PA
(2) Has not updated conformity; or has selective conformity and does not adopt
(3) Separate reporting state or combined reporting state with an 80/20 exclusion rule
(4) No general corporate income tax

Alaska

District of Columbia

Hawaii

Tax Haven Rules

Inclusion of a foreign corporation incorporated or doing business in a "tax haven" jurisdiction (AK, DC, MT, OR, RI and WV)

- In AK, a tax haven jurisdiction is a country that does not impose an income tax, or that imposes an income tax at a rate lower than 90% of the US rate
- In DC, the definition of a tax haven means a jurisdiction that may have one of statutorily enumerated traits
- In MT, the list of tax haven countries is set forth by statute and is updated as necessary
- In WV, the list of tax haven countries is based on the OECD tax haven designations
- Tax Haven Entities may bring in parts of transactions or unexpected income items

Combined Group Variations – Multiple Groups

Multiple Combined Groups may be Required

- Illinois (General/Financial Corps/Insurance Co's)
- New York / New York City
- Different lines of Business

Issues

- Getting data by entity / group
  - Cost of performance data
- Accounting records may not align with state group requirements
- Splitting entities between groups

Combined Group Variations – Multiple Groups

Multiple Combined Groups-

- **Intercompany Transactions**
  - Income / expense determination v. apportionment
  - Negative income
- **Audit Considerations**
  - Group changes
  - Fringe entities
  - Ease / benefit of including all companies
  - Get the federal return right

Combined Groups – Variations from the Usual

Arizona Combined Filing

- Corporations conducting a unitary business are required to file a water's edge combined report
- An Arizona consolidated return may be elected
- Arizona requires operational unity amongst the group members
- Interdependence of basic operations is required
- The same line of business is not determinative

Combined Groups – Variations (cont'd)

Colorado Combined Report

- A combined report generally includes all C corporations that meet three of six statutory tests for the previous two years and the year of tax filing:
  - Sales or purchases of an affiliated corporation involving another affiliate constitute 50% or more of the gross sales or purchases
  - Five or more specified services are provided to an affiliated corporation at less than an arm's length charge
  - 20% or more of the long-term debt of an affiliated corporation is owed or guaranteed by another affiliate
  - One affiliated corporation substantially uses the intellectual property of another affiliate
  - 50% or more common board of directors with another affiliate
  - 25% or more common officers with another affiliate

Group Changes

- Instant Unity
- California generally requires some (indeterminate) amount of time to elapse depending on facts and circumstances
- Colorado requires two tax years before becoming unitary
- Pre-existing history
- Multi-factor DC / Mass / WV

Case Law Developments

Illinois

- *PepsiCo Inc. and Affiliates v. Illinois Dept. of Revenue*, Ill. Tax. Trib., 16 TT 82; 17 TT 16 (2021).
- The Illinois Tax Tribunal determined that PepsiCo's domestic subsidiary, Frito-Lay North America, Inc. ("FLNA"), was not an excluded 80/20 company and should be included in the Illinois unitary group corporate income tax return.
- Illinois excludes a domestic corporation from the unitary group return if the average of its worldwide payroll and property factors is 80% or more outside the United States.
- PepsiCo formed a SMLLC, treated as a disregarded entity for federal income tax purposes, under FLNA to employ all of its U.S. paid expatriates on temporary foreign assignments. The expatriate employees were assigned to work for and under the direction and control of certain foreign companies, and the SMLLC did not pay the expatriates because the foreign companies reimbursed SMLLC for the wages it paid.
- The Tribunal considered common law employment factors and concluded that SMLLC, and as a result of its disregarded entity status, FLNA, "cannot be considered the employer of the expatriates." Furthermore, the Tribunal determined that SMLLC was nothing but a "shell corporation" and that "it must be disregarded for having no economic substance or valid business purpose." As a result, FLNA did not have adequate foreign payroll to qualify as an 80/20 company in Illinois.

Case Law Developments

Wisconsin

- *Wisconsin Dept. of Revenue v. Deere and Company,* 958 NW.2d 170 (Wis. 2021).
- The Wisconsin Court of Appeals concluded that the Wisconsin Department of Revenue is precluded from denying a taxpayer's dividends received deduction ("DRD") because it issued guidance contrary to its position taken on audit.
- Deere Luxembourg, an LLP that elected to be treated as a corporation for federal income tax purposes, was wholly owned by the taxpayer. Deere Luxembourg paid a cash dividend to the taxpayer.
- Wisconsin law provides a DRD to corporations for dividends "received from a corporation with respect to its common stock" based on certain ownership requirements. Furthermore, Wisconsin defines "corporation" to include an entity that is not organized as a corporation, but that is treated as a corporation for tax purposes.
- The Wisconsin Department of Revenue issued administrative guidance stating: "If an LLC is classified as a corporation, an LLC interest is treated in the same manner as stock." Publ'n No. 119, § IX.
- The Department of Revenue disallowed the Wisconsin DRD, asserting that such distributions were not made with respect to the "company's stock." Wisconsin law prevents the Department of Revenue from taking "a position … that is contrary to any guidance published by the [D]epartment." Wis. Stat. § 73.16.
- The Court of Appeals chose to address the issue of whether the Department may take a position that is contrary to published guidance and did not decide the matter based on statutory construction. In the court's view, Wis. Stat. § 73.16(2)(a) precluded the Department from denying the DRD taken by the taxpayer because that would contradict guidance published by the Department.

Case Law Developments

Oregon

- *Oracle Corp. & Subs. v. Ore. Dep't of Revenue*, TC 5340 (Ore. Tax Ct., Oct. 6., 2021).
- In a lengthy order issued 12/16/20, the Oregon Tax Court had denied cross-motions for summary judgment related to whether the 20% of the Subpart F income and dividends received by Oracle should be included in the denominator of its OR sales factor.
- With respect to the subpart F income, the Court held that the subpart F income did not generate "gross receipts" for purposes of determining whether OR's *exclusion* from the sales factor for certain receipts from intangible assets applied. However, the court did not determine whether those receipts might be included in the sales factor on some other basis.
  - In its reconsideration order, the court noted that both parties had moved for reconsideration on this issue – a signal to the Court that it probably missed something. The Court revised its order, holding that subpart F income *does* constitute gross receipts for purposes of the sales factor but adding that the receipts should be excluded because they arose from the "holding" of stock.

Case Law Developments

Oregon, cont'd

- *Oracle Corp. & Subs. v. Ore. Dep't of Revenue*, TC 5340 (Ore. Tax Ct., Oct. 6., 2021).
- With respect to the dividends, the Court noted that they would be subject to exclusion from the sales factor if they arose from the "holding" of an intangible asset. The court originally declined to grant summary judgment on the issue, writing that whether "Taxpayer may have influenced or controlled the CFC's business" could affect that statutory conclusion.
  - On reconsideration, the court granted the Department's motion, holding that under the statute, the dividends were excluded from the factor because they arose from "holding" an intangible asset.
  - But the Court added that the dividend amounts should be "reincluded" if they were derived from the same business activity in which Oracle operates – which the Court signaled was at least partially the case, noting that the Department had acknowledged that "the primary business activity of at least some of the CFCs is the same as that of Taxpayer."

Case Law Developments

Montana

- *Exxon Mobil Corp. v. Montana Dep't of Revenue*, 444 P.3d 407 (Mont. 2019)
- In 2019, the Montana Supreme Court held that a domestic corporation could fully deduct dividends from its 80/20 subsidiaries.
- Filing a combined return with a WE election, the taxpayer deducted dividends received from 80/20 subs that were excluded from the combined return.
- The MT DOR sought to allow a deduction of only 80% of those amounts.
- The Court allowed the full deduction, holding that MT incorporated a full deduction for amounts deductible under IRC section 243.

Case Law Developments

New Jersey

- *Infosys Limited of India, Inc. v. Dir. Div. of Revenue*, Tax Court of N.J. 012060-2016 (2018)
- Here, the Division asserted that a foreign corporation should be subject to New Jersey corporate income tax, in spite of the fact that its income was exempt by treaty under federal law.
- The Tax Court rejected the Division's petition on original hearing and reconsideration, finding that NJ's tax base starts from federal taxable income.
- It added that NJ's add-back statute did not apply to affect that conclusion, stating that the add-back only applied to specifically-stated provisions and could not be given the broad interpretation offered by the Division without undermining the legislature's expressed intent.

Case Law Developments

Georgia

- 2018 LR IT-2018-01
- In a letter ruling, a Canadian corporation requested whether it needed to file a Georgia return and/or pay Georgia taxes where it had a US filing obligation (as a result of sales solicitations) but did not have any federal taxable income because it lacked a permanent establishment (PE) and was exempt under the US-Canada treaty.
- The GA DOR assumed that, by virtue of issuing the request, the Canadian corporation was “doing business” in GA and therefore ruled that it had a technical obligation to file a GA return.
- Having said that, the DOR recognized that if the taxpayer had no US federal taxable income, then its starting point for Georgia taxable income would be identical, so it may not have any Georgia taxable income either (unless it was required to make additions from the federal starting point).

Fair Apportionment v. Tax Base

Many states have implemented combined reporting:

- The rationale is that combined reporting prevents the distortion that may result from applying the traditional three-factor formula on a separate entity basis.
- By requiring a corporate parent and its subsidiaries to file a combined report, states seek to prevent the perceived loss of state tax revenues.
- In Media General, Inc. v. SC Dep't of Rev., 694 S.E.2d 525 (2010), the taxpayer was the entity seeking combined reporting, even though South Carolina was a separate reporting state. The SC Supreme Court agreed that combined reporting should be allowed to "effectuate an equitable allocation and apportionment of the taxpayer's income."

Ways and Means “Build Back Better” Plan

Provision	House Ways and Means
GILTI	— Increase effective rate of U.S. tax on GILTI to 16.5625% by increasing the U.S. corporate rate to 26.5% and decreasing the section 250 deduction to 37.5% — Compute GILTI on a country-by-country basis (details are limited) — Reduce QBAI deduction from 10% to 5% of a CFC’s tangible assets
FDII	— Retain FDII deduction but reduce to 21.875% — Allow the section 250 deduction for GILTI and FDII to create a NOL
BEAT	— Modifies BEAT provisions, including raising the rate and revising the rules for determining modified taxable income
Section 163(j)	— Retains 163(j), but no more indefinite carryforwards
Limitation of Interest Expense under 163(n)	— General rule: the interest expense deduction of a “specified domestic corporation” that is a member of an international financial reporting group cannot exceed the “allowable percentage” of 110% of the corporation’s net interest expense — A corporation that was subject to both section 163(j) and 163(n) would apply whichever of the two provisions imposed the lower limitation — The carryover period for all disallowed interest would be limited to five tax years
Corporate Tax Rate	— Increase from 21% to 26.5%