

State Taxation of Income From Foreign Affiliates After the Tax Reform

THURSDAY, JULY 11, 2019, 1:00-2:50 pm Eastern

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State Taxation of Income From Foreign Affiliates After the Tax Reform

July 11, 2019

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State Taxation of Income From Foreign Affiliates After Tax Reform

Multistate Treatment of GILTI, FDII, Section 250
Deductions and Other Tax Issues

Presenters



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Discussion Topics for Today's Presentation

- States treatment of foreign affiliates' income before tax reform
- State Conformity & Tax Cuts and Jobs Act
- Repatriation transition tax
- GILTI and the Section 250 deduction
- FDII deduction
- Issues with apportionment factors
- Other state taxation issues

States treatment of foreign affiliates income
before tax reform

Overview of Federal International Tax Before the Tax Cuts & Jobs Act

- Domestic taxpayers were subject to tax on their worldwide income
 - Domestic corporations that earned income from non-United States sources generally paid United States income tax on all income.
 - However, federal law provided special rules for United States shareholders of certain foreign corporations, discussed below.
- Foreign taxpayers were subject to tax only on their United States source income
 - Foreign taxpayers are liable for tax on United States source income that is “effectively connected” with a United States trade or business (“effectively connected income” or “ECI”)
 - Treaty Protection: Foreign taxpayers subject to tax only if their activities in the United States gave rise to a “permanent establishment” (“PE”)

Specific Federal International Tax Provisions Before the Tax Cuts & Jobs Act

- **Subpart F Income**

- While domestic taxpayers with operations outside of the United States would presently include foreign source income in their federal taxable income (e.g., income from foreign branches or divisions), United States shareholders in Controlled Foreign Corporations (“CFCs”) could defer tax on income earned abroad by incorporating their foreign operations.
- Subpart F applies to require certain United States shareholders of CFCs to presently include certain income earned through a CFC.

Specific Federal International Tax Provisions Before the Tax Cuts & Jobs Act

- Subpart F Income
 - General Rule: A United States Shareholder may defer tax earned by a CFC unless the CFC earns “Subpart F income.”
 - Subpart F income: Defined to include certain categories of net income (i.e., after appropriate deductions) such as:
 - **Insurance income under IRC Section 953** (includes insurance income that would be taxed to a domestic insurance company unless the insurance contract is exempt through foreign licensing exceptions)
 - **Foreign Base Company Income**
 - *Foreign base company sales income*: Certain income from purchasing for, by, or to a related person (e.g., sales executed by a foreign related person)
 - *Foreign base company service income*: Certain services income earned by providing services to related persons (e.g., service corporation established abroad to provide services to affiliated corporations)
 - **Foreign personal holding company income** (e.g., rents, interest, dividends, rents, etc. from foreign personal holding companies)

Specific Federal International Tax Provisions Before the Tax Cuts & Jobs Act

- Domestic International Sales Corporations (“DISC”)
 - United States recognized disadvantage to domestic manufacturing activities by imposing tax on domestic production when sales made to foreign customers
 - Taxpayers had incentives to outsource manufacturing to foreign countries for tax purposes (in addition to other business justifications for outsourcing)
 - United States enacted provisions for the creation of DISCs:
 - Domestic manufacturing of products sold to foreign customers would be effectively exempt from tax if sold through a DISC
 - Applied a 0% effective tax rate to dividends from DISCs, and DISCs were permitted to deduct dividends paid to shareholders
 - Rules are very formalistic and possible to satisfy even without non-tax business purposes

State treatment of international transactions

- Most states provided modifications to eliminate conformity to federal international tax provisions
 - States defined taxable income to include only federal United States source income or to otherwise exclude income not attributable to domestic operations
 - States generally provided exemption or subtraction for Subpart F income
 - Subtraction for “foreign source” income
 - Subtraction for “Subpart F” income
 - Subtraction for deemed dividends or substantive equivalents (e.g., DRDs)
 - States generally provided addbacks or imposition provisions on DISC income

Constitutional limitations on State Taxation of International Transactions or Operations

- *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977): To survive Due Process and Commerce Clause challenges, a state or local tax must satisfy a four-pronged test.
 - *Substantial nexus* with the taxpayer or activity being taxed
 - *Non-discrimination* against inter- or intra-state activities
 - *Fair apportionment* of taxpayers and activities conducted in more than one state
 - *Fair relationship* to services provided by the state
- First three provide primary bases to challenge state treatment of international transactions or operations

Constitutional limitations on State Taxation of International Transactions or Operations

- *Kraft Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 505 U.S. 71 (1992)
 - United States Supreme Court struck down Iowa's tax provisions conforming to federal treatment of foreign dividends under *Complete Auto's* discrimination prong
 - Even though the federal government provided a full dividends received deduction ("DRD") for domestic dividends, the federal income tax did not provide a DRD for foreign dividends
 - United States Supreme Court held that federal conformity does not provide a rational basis to discriminate against foreign commerce

Constitutional limitations on State Taxation of International Transactions or Operations

- Fair apportionment challenges:
 - *Hans Rees' Sons, Inc. v. North Carolina* (1931) – Found unfair apportionment where taxpayer showed that state formulary apportionment (single property factor) taxed 250% more income than the taxpayer's separate accounting.
 - *Butler Bros. v. McColgan* (1942) – Found separate accounting unpersuasive to impeach a taxing state's formulary apportionment; acknowledged separate accounting subject to potential abuse.
 - *Moorman Manufacturing Co. v. Bair* (1978) – Reaffirmed that use of apportionment formula (even single factor) presumptively constitutional; Iowa's use of single sales factor permissible even though neighboring states (where taxpayer also paid tax) used different formula resulting in some double taxation.

Constitutional limitations on State Taxation of International Transactions or Operations

- *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983)
 - The United States Supreme Court upheld California's imposition of worldwide combined reporting under fair apportionment prong.
 - Domestic corporate affiliates and foreign corporate affiliates both subject to combination if they met the combined reporting requirements (e.g., unitary business).
 - Same rules for calculating the apportionment formula applied to domestic corporate affiliates and foreign corporate affiliates.
 - Foreign source income can be included in state taxable income when equal apportionment rules apply to domestic and foreign activities.
 - “Internal Consistency”: If every jurisdiction adopted the same rules, would the taxpayer be subject to double taxation?
 - Later cases (e.g., *Wynne v. Compt. of Treasury of Mar.* (2015)) found internal consistency could invalidate tax as facially discriminatory.

State Conformity & Tax Cuts and Jobs Act

State Methods of Internal Revenue Code Conformity

H.R. 1 “Tax Cuts and Jobs Act”

- Date of Enactment is December 22, 2017
- “Rolling” Conformity – the IRC “as amended”
 - These states will automatically conform to the TCJA unless they decouple
 - 26 states, including Illinois, Massachusetts, Missouri, New York
- “Fixed-date” Conformity - the IRC “as in effect on” or “as amended through” a specific date
 - These states will not conform to the TCJA until they update their IRC conformity date (assuming no decoupling)
 - 21 states, including California, Indiana, Michigan, North Carolina
- “Selective” conformity - only specific IRC provisions on a “rolling” or “fixed-date” basis
- Line 28 vs. Line 30 conformity - Conformity to “Special Deductions” (e.g., DRD) and Net Operating Loss deductions.

State Impact of the Federal Deemed Repatriation Transition Tax

State Impact of the Federal Deemed Repatriation Transition Tax

Amended IRC Section 965

- U.S. shareholder (owns 10% or more of stock by vote or value) of “deferred foreign income corporation” must determine the DFIC’s post-1986 accumulated earnings and profits that have not been subject to U.S. tax as of November 2, 2017 or December 31, 2017.
- The U.S. shareholder’s pro rata share of the DFIC’s deferred E&P is treated as a Subpart F income inclusion under IRC Section 951(a) in federal taxable income of the U.S. shareholder for the 2017 taxable year (the “inclusion amount”).
- The “inclusion amount” is subject to reduced rates of tax – 15.5% on deferred earnings held in cash or cash equivalent and 8% on deferred earning held in other property.
 - To arrive at the 15.5% or 8% effective rates of tax, a deduction (“participation exemption”) is provided by IRC Section 965(c).

State Impact of the Federal Deemed Repatriation Transition Tax

Amended IRC Section 965 (con't)

- U.S. shareholder is provided an election to defer payment of DRTT over 8 annual installments.
- Future distributions of deemed repatriated earnings by the DFIC are tax-free under IRC Section 959.
- IRS released final regulations under IRC Section 965 on January 15, 2019.

State Impact of the Federal Deemed Repatriation Transition Tax

IRS FAQs (issued March 13, 2018)

- The FAQs address tax return reporting of the section 965(a) and 965(c) amounts, as well as the mechanics of making the tax payment deferral installment elections.
- A corporation does not report these amounts on its Form 1120.
 - The section 965(a) income and section 965(c) deduction are reported on line 1 and line 4, respectively, of the Form 965 Transition Tax Statement.
 - The federal transition tax is computed on the “net amount” of the section 965(a) inclusion minus the section 965(c) deduction.
 - For its 2017 taxable year, a corporation will make two federal income tax payments - the payment of the section 965 deemed repatriation transition tax with the Form 965 Transition Tax Statement, and the payment, if any, of its regular federal corporation income tax with its Form 1120.
- S corporations, partnerships, and other PTEs will issue K-1s reflecting each shareholder’s, partner’s, or member’s share of the entity’s section 965(a) income amount and share of the entity’s section 965(c) deduction amount.
- Individual taxpayers will report the “net amount” on their federal Form 1040, line 21 “other income.”

State Impact of the Federal Deemed Repatriation Transition Tax

State Legislative Reactions – Corporate Income Tax

- Georgia (S.B. 918) – Report IRC Section 965(a) income = 100% DRD
 - **Add-back IRC Section 965(c) deduction**
- Indiana (H.B. 1316) – Report IRC § 965(a) income, eligible for DRD
- New York (S. 7509) – IRC Section 965 income qualifies as “exempt CFC income”
 - **Add-back IRC Section 965(c) deduction**
- North Carolina (S.B. 99) – IRC Section 965(a) income qualifies for subtraction modification (net of related expenses)
 - **Add-back IRC Section 965(c) deduction**
- Oregon (S.B. 1529) – IRC Section 965(a) income qualifies for partial DRD
 - **Add-back IRC Section 965(c) deduction**
 - **Non-refundable tax credit**
- Utah (H.B. 2002) – IRC Section 965(a) income included in Utah “unadjusted income” (silent regarding DRD and IRC Section 965(c) deduction)

State Impact of the Federal Deemed Repatriation Transition Tax

State Administrative Reporting Guidance

- Alabama (Section 965 Notice) – report IRC Section 965(a) income, eligible for 100% DRD
 - **Report IRC Section 965(c) deduction on lines 23 or 24, Schedule A of Form 20C which flows to calculation of Alabama net income**
- Colorado (Section 965 Supplemental Instructions) – report “net amount,” eligible for CO foreign source income exclusion
 - **No add-back or separate state deduction because only “net amount” from Form 965 is reported**
- Connecticut (Office of Commissioner Guidance, OCG-4) – report IRC Section 965(a) income, eligible for 100% DRD (but apply new statutory 5% expense disallowance offset)
 - **“Disregard” IRC § 965(c) deduction**
- Florida – Tax Information Pub. No. 18C01-01 – IRC Section 965(a) income “excluded”

State Impact of the Federal Deemed Repatriation Transition Tax

State Administrative Reporting Guidance

- Georgia (Policy Bulletin 2018-01) – “net amount” qualifies for 100% DRD (net of expenses)
 - **Taxpayers will not be required to follow the statute and report IRC Section 965(a) income, add-back IRC Section 965(c) deduction, and then claim 100% DRD.**
- Illinois (Information Bulletin 2018-23) – “net amount” qualifies for DRD
 - **No IRC Section 965(c) deduction add-back or separate state deduction because only “net amount” from Form 965 qualifies for DRD**
- Indiana (Information Bulletin 116) – report IRC Section 965(a) income and claim DRD (amount based on percentage of ownership).
- Michigan (IRC 965 Corporate Income Tax Guidance) – report IRC Section 965(a) income and claim 100% DRD.
- New York – See Notice N-18-7 for reporting guidance

State Impact of the Federal Deemed Repatriation Transition Tax

State Administrative Reporting Guidance

- Pennsylvania (Information Notice 2018-1) – “net amount” qualifies for DRD
 - **No IRC Section 965(c) deduction add-back or separate state deduction because only “net amount” from Form 965 qualifies for DRD.**
- Rhode Island – See new final regulations, 280-RICR-25-20-15.
- Tennessee (Important Notice 18-05) – “net amount” received by C corp or S corp excluded from net earnings
 - **No IRC Section 965(c) deduction add-back or separate state deduction because only “net amount” from Form 965 is excluded from net earnings**
- Vermont (IRC Section 965 Repatriation Guidance) – “net amount” is included in RI taxable income – no DRD.

State Impact of the Federal Deemed Repatriation Transition Tax

Federal Tax Payment Deferral Elections – State Recognition

- Colorado (IRC Section 965 Supplemental Instructions) – will not follow
- Connecticut (OCG-4) – will not follow (but individuals can request CT payment plan)
- Illinois (Information Bulletin 2018-23) – will not follow
- Indiana (Information Bulletin 116) – will not follow
- Oklahoma (H.B. 3715) – will follow for any taxpayer (but silent with regard to S corporation shareholder “triggering event” deferral)
- Rhode Island (280-RICR 20-25-15) – will not follow
- Utah (S.B. 244) – will follow, but only for corporation income tax

State Impact of the Federal Deemed Repatriation Transition Tax

Other SALT Corporate Income Tax Issues for IRC Section 965

- Under IRC Section **965(b)** the determination of post-1986 E&P of the DFIC allows the reduction in the E&P of the DFIC by E&P deficit foreign corporation(s).
 - **States (separate return and combined reporting) may not allow netting or may only allow netting of DFICs with E&P deficit FCs owned by the same filing entity, but not netting of DFICs with E&P deficit FCs owned by other related entities within the global affiliated group.**
- Idaho (Temp. Rule 017T) – calculate IRC Section 965(a) amount for Idaho purposes by applying IRC Section 965(b).
- New York (S. 7509) – calculation of IRC Section 965(a) amount that qualifies as “exempt CFC income” is determined using IRC Section 965(b) netting.

State Impact of the Federal Deemed Repatriation Transition Tax

Other SALT Corporate Income Tax Issues for IRC Section 965

- Wholly owned CFC – State Combined Reporting “Haircuts” - A number of combined reporting states provide only a partial Subpart F income (or foreign-source DRD) even with respect to wholly owned CFC.

Alaska (80%)	Maine (50%)	New Mexico (no DRD if elect combined or consolidated)
California (75% for “qualifying dividends”)	Minnesota (80%)	North Dakota (70%)
Idaho (85%)	Montana (80%)	Oregon (80%)
Kansas (80%)	New Hampshire (factor rep)	Utah (50% - only if CFC is unitary)
		Vermont (fully included)

State Impact of the Federal Deemed Repatriation Transition Tax

Other SALT Corporate Income Tax Issues for IRC Section 965

- Expense disallowance – many state Subpart F income subtractions or foreign-source DRDs require add-back of directly or indirectly related expenses.
- The “Day 1 / Day 2 Issue” – Future actual distribution of foreign earnings
 - For federal purposes, subsequent actual DFIC distributions are not taxed since the distribution is out of previously taxed income (per IRC Section 959)
 - Will a state conform to federal PTI treatment of the “Day 2” distribution (especially if the “Day 1” deemed repatriation was not included in state taxable income)?
 - IRC Section 959 is an exclusion from federal gross income; state would have to depart from this treatment.
 - It can be common for unitary water’s-edge states to depart from IRC § 959 and apply their own DRDs.

State Impact of the Federal Deemed Repatriation Transition Tax – Personal Income Tax and PTEs

State Personal Income Tax - Overview

- Individuals may incur a state tax on the deemed repatriation under IRC Section 965 if they directly own a CFC with foreign E&P directly or through a PTE.
- Thus, individuals may be subject to state income tax on repatriated foreign E&P on their 2017 return.
- Moreover, most states (at this point) have not provided an election to pay the repatriation tax over an extended period.
 - **Absent state legislation that allows an election to pay the repatriation tax over an extended period, individuals that have repatriated foreign income on their 2017 federal return may be required to pay the entire transition tax in 2017.**

State Impact of the Federal Deemed Repatriation Transition Tax – Personal Income Tax and PTEs

State Personal Income Tax - Overview

- Most states start with federal AGI.
- Pursuant to the IRS FAQs, the IRC Section **965(a)-(c)** “net amount” is included on line 21, “other income,” of an individual’s Form 1040.
- Few states allow a personal income tax deduction for (or exclusion of) Subpart F income.

State Impact of the Federal Deemed Repatriation Transition Tax – Personal Income Tax and PTEs

State Reactions – Administrative Reporting Guidance

- Alabama (IRC Section 965 Notice) – “net amount” is excluded from an individual’s AL income (but only if a direct shareholder in foreign corporation).
- Colorado (IRC Section 965 Supplemental Instructions) – include “net amount” reported on federal Form 1040, line 21 on line 1 of CO return (federal tax payment deferral election is not followed).
- Connecticut (OCG-4) – include “net amount” reported on federal Form 1040, line 21 on line 1 of CT return (federal tax payment deferral election is not followed, but can request payment plan).
- Georgia (Policy Bulletin) – include “net amount” in GA taxable income.
- Indiana
 - H.B. 1316 - follows IRC 965 Transition Tax Statement reporting - Section 965(a) amount included in federal (and IN) AGI; add-back section 965(c) deduction.
 - Information Bulletin 116 - explains how to report IRC Section 965(a) income and add-back the section 965(c) deduction, including flow-through from a PTE.

State Impact of the Federal Deemed Repatriation Transition Tax – Personal Income Tax and PTEs

State Reactions – Administrative Reporting Guidance

- New Jersey (Notice re 965) – Section 965(a) inclusion amount included in NJ gross income (silent regarding section 965(c) deduction).
- New York (Notice N-18-4) – “net amount” included in NY taxable income (federal tax payment deferral elections not followed).
- Oregon *ReveNews* (Apr. 12, 2018) – Section 965(c) deduction must be added back to the “net amount” included in federal AGI (federal tax payment deferral elections not followed).
- Pennsylvania (Information Notice 2018-1) – “net amount” is excluded from PA gross income
- Rhode Island (Advisory 2018-19) – IRC § 965 “income” is included in RI taxable income (silent regarding section 965(c) deduction) (federal tax payment deferral elections not followed).
- Vermont (IRC Section 965 Repatriation Guidance) – include “net amount” in VT taxable income.

State Impact of the Federal Deemed Repatriation Transition Tax –S Corporation Shareholders

IRC Section 965(i) Special Rules for S Corporation Shareholders

- When an S corporation is a U.S. shareholder of a DFIC, its shareholders may elect to defer payment of their net DRTT liability until the taxable year in which a “triggering event” occurs.
- “Triggering events”
 - S corporation ceases to be an S corporation;
 - Liquidation of or sale of substantially all the assets of the S corporation;
 - Cessation of S corporation business; or
 - Transfer of “any share of stock in such S corporation” by the taxpayer (a partial transfer is a trigger only with respect to the shareholder’s net tax liability allocable to the partial stock transfer.)
 - Not treated as a “triggering event” if the transferee agrees to be liable for the DRTT liability.
- After “triggering event,” shareholder can still elect to pay tax in installments.

State Impact of the Federal Deemed Repatriation Transition Tax - PTEs

Special State Treatment for PTEs and Owners of PTEs

- Alabama (IRC Section 965 Notice) – individual owner of S corporation or other PTE reports “net amount” in AL income (**unlike individual who is a direct owner of a foreign corporation and excludes the “net amount” from AL income**).
- New York City (Finance Memorandum 18-4) – “net amount” is subject to General Corporation Tax (for S corporations) and Unincorporated Business Tax (for partnerships and LLCs); no “exempt CFC income” provision
 - **Federal tax payment deferral elections not followed**
- Tennessee (Important Notice 18-05) – “net amount” received by PTEs (other than S corporations) or REITs is included in income and eligible for DRD, but only if PTE/REIT satisfies 80% ownership requirement

RTT Apportionment Issues

Issues with apportionment factors – Repatriation Transition Tax

General approach to factor representation for foreign dividend and subpart F income

- Most states have some form of factor relief for dividend income
 - Some states may exclude from sales factor numerator and denominator under occasional-sale type rules
- Most states do not permit inclusion of foreign subsidiaries' apportionment factors
- Appropriate (i.e., equal to domestic) factor representation largely non-existent absent equitable apportionment relief
 - States will rely on equitable apportionment and fair apportionment case law to require taxpayer to make request for non-statutory treatment based on heavy burden to proving unfair apportionment

Issues with apportionment factors – Repatriation Transition Tax

Very little state guidance on factor representation for IRC 965 Income

- Massachusetts – Excluded
 - Deemed repatriation income is excluded from the sales factor. Mass. Tech. Info. Release, TIR-18-11 (Oct. 4, 2018).
- Missouri – Excluded
 - The Department issued guidance that would effectively exclude IRC 965 income from the sales factor (whether the taxpayer has elected use Missouri’s three-factor apportionment formula or one of the state’s single sales factor apportionment formulas).
 - The Department’s guidance also effectively excludes IRC 965 income, either as income that cannot be allocated to Missouri or as income subject to a full DRD. Mo. Policy Guidance, IRC Section 965 Transition Tax: Tax Years 2016 and 2017; see also Missouri Forms MO-1120, MO-MS, and corresponding instructions.
- Pennsylvania – Excluded
 - IRC 965 income is a dividend for corporate income tax purposes, and dividends are excluded from sales factor. Penn. Notice 2018-01 (Apr. 20, 2018).

Issues with apportionment factors – Repatriation Transition Tax

Very little state guidance on factor representation for IRC 965 Income

- Indiana – Partial inclusion
 - IRC 965 income, less applicable DRD, included in taxpayer's sales factor denominator. Ind. Info. Bulletin No. 116 (Jul. 2018).
- Maine – Partial inclusion
 - IRC 965 income, less applicable 80% subtraction, included in taxpayer's sales factor apportionment calculation. Me. Tax Alert, Vol. 28, Issue 11 (Oct. 2018).
- New Jersey – Partial inclusion
 - Legislative adopted enacted independent apportionment ratio for IRC 965 income that is the lower of:
 - 3.5%; or
 - average of taxpayer's allocation factor over three years' period of 2014 through 2016.

N.J. Stat. Ann. 54:10A-4.

Issues with apportionment factors – Repatriation Transition Tax

Very little state guidance on factor representation for IRC 965 Income

- New Mexico – Partial inclusion
 - 30% exclusion of net IRC 965 income in lieu of apportionment relief
 - State reasoned: too onerous for taxpayer to determine amount of foreign subsidiaries' factors that should be included in denominator because IRC 965 income amounts have been accrued over long period of time.

N.M. Bulletin B-300.17 (Jan. 1, 2019).
- Oregon – Partial inclusion
 - Factor relief differs depending on whether IRC 965 income is included before or after state's January 1, 2018 transition from cost of performance sourcing to market-based sourcing:
 - For tax years before January 1, 2018, deemed repatriation amount is excluded from sales factor unless repatriation gross receipts are derived from taxpayer's primary business activity.
 - For tax years on or after January 1, 2018, the deemed repatriation amount is excluded from sales factor unless repatriation gross receipts are received from transactions and activities in the regular course of taxpayer's trade or business (which the Department concluded will never be the case).

Or. Rev. Bulletin No. 2018-01 (Nov. 9, 2018).

Issues with apportionment factors – Repatriation Transition Tax

Very little state guidance on factor representation for IRC 965 Income

- Rhode Island – Partial inclusion
 - Regulatory provisions allow factor representation for IRC 965 income, as reduced by DRD, in sales factor denominator. R.I. Code of Regs. 20-25-15.8.
- Maryland – Alternative Apportionment Relief
 - The Department has issued guidance allowing a taxpayer to petition for alternative apportionment if the taxpayer believes the apportionment formula does not fairly reflect the income attributable to Maryland. Md. Tax Alert, Md. Guidance on the Reporting and Taxation of IRC 965 Repatriation Income for Tax Year 2017 (Oct. 5, 2018).
- Utah
 - IRC 965 income is multiplied by a Utah apportionment fraction to arrive at Utah apportioned IRC 965 income. A portion of the factors from each foreign subsidiary paying the IRC 965(a) deferred foreign income can be included in the fraction. Utah Form TC-20R - Tax on Deferred Foreign Income (IRC 965(a)).

Issues with apportionment factors – Repatriation Transition Tax - PTEs

Special Apportionment Treatment for PTEs

- Indiana (Information Bulletin 116) – IRC Section 965(a) income is not treated as a “receipt” for purposes of apportionment by S corporations and other PTEs (unlike C corporation treatment).
- New York (Notice N-18-8) - “net amount” when received by a S corporation is treated as “dividends from stock” and generally excluded from the NY business allocation factor (sales factor), except for certain financial organizations.

GILTI and the Section 250 deduction

State Impact of Global Intangible Low-Taxed Income (“GILTI”) – IRC Section 951A

- Effective for taxable years beginning after December 31, 2017, new IRC Section 951A will impose a 10.5% tax on a U.S. shareholder’s share of a CFC’s “global intangible low-taxed income.”
 - GILTI is defined as a CFC’s net income (after appropriate deductions) to the extent such net income exceeds 10% of the taxpayer’s “qualified business asset investments” (“QBAI”), a number that is based on the taxpayer’s adjusted basis in depreciable property.
- Generally will impact U.S. shareholders of CFCs that have heavy concentration of intangible assets compared to fixed/tangible assets (or high income relative to low depreciable assets).
 - Industries most likely impacted: technology; pharmaceutical; manufacturing; banking and financial services
- GILTI is included in the U.S. shareholder’s FTI under section 951A and then a deduction is provided by new IRC Section 250 in an amount under a calculation that arrives at a 10.5% effective federal tax rate on the GILTI.
- At federal level, foreign tax credits provide relief. Generally no state corollary for foreign tax its.

State Impact of GILTI

- Did you know that a company's Global Intangible Low-Taxed Income (GILTI) amount can be different for state purposes and federal purposes?
- State tax base inclusion / exclusion. GILTI is included in the U.S. shareholder's FTI under section 951A, a new provision in Subpart F. However, it is not a Subpart F income inclusion under IRC Section 951(a) nor included in the definition of "subpart F income" under IRC Section 952.
- In certain states, GILTI income will be deductible while in other states it will be taxable. For states whose Subpart F income deduction is operative through the state's foreign source DRD, it is uncertain if the GILTI will qualify as a foreign source dividend.
 - Could state case law treating Subpart F income as a "deemed dividend" eligible for state DRD apply to GILTI as well?
- If a state includes all or a portion of GILTI in state taxable income, what is the effect on the state's sales factor of the apportionment formula. Should GILTI be included in the sales factor?
 - ILTI is income of the CFC.
 - Is GILTI unitary, business income of the water's-edge group?

State Impact of GILTI

- Is there the potential for double inclusion of GILTI in water's-edge states with "tax haven" provisions?
- Unlike the DRTT's new IRC § 965(c) deduction, new IRC § 250 FDII deduction is included in Subchapter B, Part VIII "Special Deductions for Corporations" of the IRC.
 - Will not enter into FTI for a "line 28" state.
 - As a special deduction, it is not available to S corporations, partnerships/other PTEs, and individuals.

GILTI Apportionment Issues

Issues with apportionment factors – GILTI

General approach to factor representation for foreign dividend and subpart F income

- Most states have some form of factor relief for dividend income
 - Some states may exclude from sales factor numerator and denominator under occasional-sale type rules
- Most states do not permit inclusion of foreign subsidiaries' apportionment factors
- Appropriate (i.e., equal to domestic) factor representation largely non-existent absent equitable apportionment relief
 - States will rely on equitable apportionment and fair apportionment case law to require taxpayer to make request for non-statutory treatment based on heavy burden to proving unfair apportionment

Foreign Derived Intangible Income (FDII)

Foreign Derived Intangible Income (FDII)

- The 2017 Tax Act provides US companies with a new permanent deduction: Foreign-Derived Intangible Income (FDII). An incentive for C corporations to generate revenue from serving foreign markets, the provision applies a preferential tax rate to eligible income.
- Did you know that a company's Foreign Derived Intangible Income (FDII) amount can be different for state purposes and federal purposes?
 - FDII should be calculated on an entity by entity basis if any separate returns are filed.
- Certain states will incorporate the IRC section 250 FDII deduction while other states may not. The state income tax starting point (Line 28 vs. Line 30) will impact the treatment.

Foreign Derived Intangible Income (FDII)

- The new IRC §250 deduction likely will be treated as a “special deduction” on Line 29b of Form 1120.
- For states using Form 1120, Line 28 as the starting point for the computation of state taxable income, the states will likely take the position that the federal FDII deduction is not allowed unless the state enacts a modification that allows a deduction for FDII
- For states using Form 1120, Line 30 as the starting point for the computation of state taxable income, the federal FDII deduction should be allowed unless the state specifically decouples from IRC §250 or enacts an addback modification
- Similarly, a state may allow the IRC Section 250 GILTI deduction, but that does not mean it will also allow the IRC Section 250 FDII deduction.

FDII Deduction – State Issues

- How should “Deduction Eligible Income” be computed when a state decouples from various IRC provisions which change a corporation’s taxable income (e.g., bonus depreciation)?
- IRC 250 says deduction is impacted if a corporation’s GILTI and FDII exceed its Federal Taxable Income. FTI is determined after a corporation’s NOL is applied so it is possible that a 250 deduction is not available if a corporation utilizes an NOL. If this is the case then this will create an additional complexity on state income tax returns because it is not clear how a taxpayer’s federal NOL usage should impact the state starting point.

FDII Deduction – State Issues (cont.)

- The “shared” IRC 250 FTI cap will create complications if a state decouples from GILTI or provides a subtraction for GILTI. In this situation what happens to the corresponding 250 deduction that relates to GILTI with respect to the overall “cap”?
- Should the FDII deduction be available in “line 28” states?
 - States are not “line 28” by statute but instead appear to be “line 28” states by administrative practice (e.g., included in the state return’s instructions).

2019 State Reactions to TCJA

2019 Federal Tax Reform Conformity/Decoupling Developments

Arizona

H.B. 2757, enacted May 27, 2019

- Updates Arizona's IRC conformity date. For tax years beginning from and after December 31, 2017 through December 31, 2018, Arizona now conforms to the IRC in effect on January 1, 2018. For tax years beginning from and after December 31, 2018, Arizona conforms to the IRC in effect on January 1, 2019, including those IRC provisions that became effective during 2018.
- Amends the Arizona foreign source DRD to include as dividend income the IRC Section 78 gross-up amount, IRC Section 951A GILTI, and subpart F income ("as defined in Section 952 of the Internal Revenue Code"). However, this amendment is effective for taxable years beginning after December 31, 2018.
- Arizona corporate taxpayers will be required to add-back the IRC Section 250(a)(1)(B) GILTI deduction and the IRC Section 245A foreign-source DRD (otherwise eligible for the Arizona DRD) to the federal taxable income starting point when calculating Arizona taxable income. However, these addition modifications are likewise applicable "to taxable years beginning from and after December 31, 2018."

2019 Federal Tax Reform Conformity/Decoupling Developments

Idaho

H.B. 183, enacted Apr. 3, 2019

- Amends portions of Idaho's 2018 federal tax reform decoupling legislation. For corporation income tax purposes only, Idaho will not require an addition modification for amounts deducted for federal tax purposes under IRC Section 245A (foreign-source DRD), IRC Section 250 (GILTI and FDII deductions), and IRC Section 965 (the Section 965(c) deduction).
- Removal of the addition modification for IRC Section 245A and IRC Section 250 is effective retroactively to tax years beginning on or after January 1, 2018.
- Removal of the addition modification for the IRC Section 965(c) deduction is effective retroactively to tax years beginning on or after January 1, 2017.
- Idaho foreign-source DRD (partial 85% DRD for water's-edge filers) will now be applicable to IRC Section 245A foreign-source dividends and the "net amount" of IRC Section 965 income and IRC Section 951A GILTI.

2019 Federal Tax Reform Conformity/Decoupling Developments

Maryland

Tax Alert 04-19 (Apr. 17, 2019)

- For corporate income tax purposes, IRC Section 951A GILTI income will not qualify for the Maryland DRD (which does apply for corporate income tax purposes to IRC Section 965 and Subpart F income.)
- IRC Section 250(a)(1)(B) GILTI deduction will be allowed.
- GILTI included in the sales factor numerator based on the average of the taxpayer-recipient's MD average property and payroll; manufacturing corporations are required to use SSF and excluded GILTI from the factor.
- For personal income tax purposes, the total GILTI amount is included in taxable income of MD resident individuals and pass-through entities. A PTE includes the total GILTI amount in its sales factor numerator based on the average of its property and payroll factors. For a nonresident individual subject to MD PIT, the total GILTI amount is excluded as income from intangibles.

2019 Federal Tax Reform Conformity/Decoupling Developments

Massachusetts

H. 4930, enacted Oct. 23, 2018

- Effective for the last taxable year beginning before Jan. 1, 2019, and for subsequent tax years, the definition of "dividend" for corporate excise tax and financial institution excise tax purposes was amended to include "amounts included in federal gross income pursuant to" IRC Sections 951 (including IRC Section 965) and 951A.
- The 95% DRD is also now explicitly allowed for subpart F income included in a taxpayer's federal gross income under IRC Section 951 (including IRC Section 965(a) income) and GILTI included under IRC section 951A.
- H. 4930 also decouples from the IRC with respect to IRC Section 245A (foreign source DRD), IRC Section 250 (both GILTI and FDII deductions), and IRC Section 965(c) deduction.
- H. 4930 also excludes IRC Section 965(a) income and IRC Section 951A GILTI from the sales or receipts factors for corporate excise tax and financial institution excise tax purposes.

2019 Federal Tax Reform Conformity/Decoupling Developments

Massachusetts

H. 3506, enacted Mar. 29, 2019

- For personal income tax purposes, requires IRC Section 965(a) income to be reported, and it is treated as Part A interest and dividend income subject to the 5.05% rate.
- The IRC Section 965(c) deduction is not allowed. Instead, individuals are allowed a 60% deduction of the IRC Section 965(a) amount.
- H.B. 35056 operates retroactively to tax years beginning on or after Jan. 1, 2017; however, reporting of IRC Section 965 amounts for Massachusetts personal income tax purposes will not be required until the tax year ending Dec. 31, 2019.
- If a federal election to defer payment of tax has been elected under IRC Section 965(h), Massachusetts will follow the federal election, but only for personal income tax purposes. However, MA will not follow the IRC section 965(i) tax payment deferral election for S corporation shareholders.

2019 Federal Tax Reform Conformity/Decoupling Developments

Minnesota

H.F. 5, enacted May 31, 2019

- Updates Minnesota's December 16, 2016 IRC conformity date to the IRC "as amended through December 31, 2018." The update is "effective retroactively at the same time the changes became effective for federal purposes."
- However, both IRC Section 965(a) "deferred foreign income" and IRC Section 951A GILTI will be treated as subtraction modifications.
 - The IRC Section 965(c) deduction, and the IRC Section 250(a)(1)(A) and (B) FDII and GILTI deductions will be treated as addition modifications.
- The legislation conforms to IRC Section 163(j) and requires the business interest expense limitation be determined on a combined reporting group basis.

2019 Federal Tax Reform Conformity/Decoupling Developments

Mississippi

Notice 80-19-001 (Jan. 24, 2019)

- Mississippi will treat deemed repatriations under IRC section 965 as nonbusiness dividend income and allocable to the state if the recipient's commercial domicile is in Mississippi.
- GILTI income under IRC section 951A will not be subject to MS corporate income tax.

2019 Federal Tax Reform Conformity/Decoupling Developments

Missouri

Policy Guidance (Jan. 31, 2019)

- The "net GILTI amount" (IRC section 951A GILTI less "related Section 250 deductions") is reported on line 1 of MO-1120. If classified as business income, then the MO apportioned amount of the "net GILTI amount" is entered on line 10 of MO-1120 and subtracted in accordance with the MO DRD.
- For taxpayers using the three factor apportionment formula, the net GILTI amount is included in the sales factor. For taxpayers electing SSF apportionment ("Method 2" of "Method 2A"), the apportioned net GILTI amount is also entered on line 10 of MO-1120 as a non-Missouri source dividend, and entered on MO-MS Part 2, line 12. If the net GILTI amount is classified as nonbusiness income, then it is reported on Form MO-NBI and on MO-MS, Part 1, lines 9 or 12, with a detailed description explaining the nonbusiness treatment.
- A separate company that is a member of an affiliated group filing a federal consolidated return must determine its net GILTI amount "as if" it filed a separate federal return.

2019 Federal Tax Reform Conformity/Decoupling Developments

New Jersey

Technical Bulletin, TB-88 (Apr. 23, 2019)

- To the extent a foreign affiliate is included in a NJ combined report and another member of the group has included GILTI income with respect to that foreign affiliate, Division of Taxation announced in TB-88 that it is developing a schedule to eliminate the double taxation of GILTI.

2019 Federal Tax Reform Conformity/Decoupling Developments

New York

A.B. 8433, enacted June 25, 2019

- Provides a partial subtraction for the gross amount of IRC Section 951A GILTI.
- Effective for tax years beginning on or after Jan. 1, 2019, 95% of GILTI (gross, not net of IRC Section 250(a)(1)(B) deduction) qualifies as "exempt CFC income", which is subtracted from NY business income.
- Also effective for tax years beginning on or after Jan. 1, 2019, the IRC Section 250(a)(1)(B) GILTI deduction will be treated as an addition modification to entire net income for NY corporation franchise tax purposes (and insurance company franchise tax purposes for life insurance companies).
- The 5% of the gross GILTI amount that is not subtracted from NY entire net income will be included in the denominator, but not the numerator, of the NY business apportionment factor (single sales factor).

2019 Federal Tax Reform Conformity/Decoupling Developments

New York

Technical Memorandum, TSB-M-19(1)C (Feb. 8, 2019)

- Based on 2018 legislation, a New York C corporation treats IRC Section 965(a) income as exempt CFC income for Corporation Tax purposes, net of any interest expense deductions directly or indirectly attributable to such income (or net of the 40% interest expense safe harbor election.) Therefore, 60% of the IRC Section 965(a) amount qualifies as exempt CFC income (if a taxpayer makes the safe harbor election). The deduction under IRC Section 965(c) is not allowed.
- According to the Technical Memorandum, the IRC Section 965(a) amount is excluded from the NY sales factor numerator and denominator.
- The Technical Memorandum also addressed GILTI under IRC Section 951A, but has not been updated to address the new legislation discussed on the previous slide. The guidance remains relevant to the 2018 tax year.
- Regarding IRC Section 951A GILTI, the "net GILTI income" (i.e., the IRC Section 951A GILTI income amount less the IRC Section 250(a)(1)(B) "GILTI deduction") is included in NY entire net income (it does not qualify as exempt CFC income). Any IRC Section 78 dividend gross-up is not included in NY entire net income. If the stock of the CFC that generates GILTI income is business capital, then the net GILTI amount is included in a New York C corporation taxpayer's New York sales factor denominator.
- The Technical Memorandum also addresses New York S corporation, insurance company, and exempt organization treatment of IRC Section 965 and IRC Section 951A income for New York State tax purposes.

2019 Federal Tax Reform Conformity/Decoupling Developments

Pennsylvania

Corporation Tax Bulletin 2019-02 (Jan. 24, 2019)

- Addresses the Pennsylvania tax treatment of GILTI and FDII.
- The gross amount of IRC Section 951A GILTI income (without reduction for the IRC Section 250(a)(1)(B) GILTI deduction) is included in the corporate net income tax base, but will be treated as a dividend for corporate net income tax purposes and subject to a DRD based on IRC Section 243.
- Pennsylvania is a "rolling" IRC conformity state and will conform to the TCJA amendments to IRC Section 243 that are effective for taxable years beginning after December 31, 2017.
- No GILTI deduction under IRC Section 250(a)(1)(B) or FDII deduction under IRC Section 250(a)(1)(A) is allowed for corporate net income tax purposes.
- Because Pennsylvania will treat the GILTI income as a dividend, it will not be reflected in the sales factor.

2019 Federal Tax Reform Conformity/Decoupling Developments

Philadelphia Advisory Notices

- *Repatriation Transition Tax:*
 - For BIRT purposes, Philadelphia provides that the *net* RTT is eligible for a dividends received deduction if the dividends are received from another corporation of the same affiliated group, or the receiving corporation or partnership owns at least 20% of the voting power of all classes of stock and at least 20% of each class of nonvoting stock.
 - Philadelphia does not provide for an election to pay RTT over the 8-year period.
<https://www.phila.gov/media/20190201090603/Advisory-notice-repatriation-transition-tax-BIRT-update-January-2019.pdf>.
- *GILTI:*
 - For purposes of the BIRT, GILTI income is included in the BIRT income tax base as a dividend.
 - Philadelphia does not conform to IRC § 250 deduction.
 - If receipts are received from another corporation of the same affiliated group, or if the receiving corporation or partnership owns at least 20% of the voting power of all classes of stock and at least 20% of each class of nonvoting stock, the GILTI income is excluded from the taxable receipts and net income tax bases, and sales factor for the apportionment of taxable income. <https://www.phila.gov/media/20190215122221/Advisory-notice-GILTI-and-FDII-tax-BIRT-2019-February.pdf>.
- *FDII:* FDII is included in the BIRT income tax base. Philadelphia does not permit a deduction for FDII under IRC § 250.

2019 Federal Tax Reform Conformity/Decoupling Developments

Tennessee

S.B. 558, enacted May 8, 2019

- Gross GILTI and IRC section 965(a) income that is included in FTI is subtracted
- Five percent of the gross GILTI amount or IRC section 965(a) income amount is then added-back.
- Effective for tax years beginning on or after January 1, 2018.
- The effective date of S.B. 558 means it will not apply to most taxpayers for purposes of TN excise tax treatment of IRC Section 965(a) income. For most taxpayers, Section 965 was a 2017 tax year issue. Instead, Important Notice 18-05 (April 2018) should still apply for the 2017 tax year, pending future guidance from the TDOR. Per Important Notice 18-05, C corps and S corps exclude the "net" IRC section 965 amount from TN net earnings. Partnerships/LLCs include in net earnings and deduct per foreign-source DRD (80% or more ownership required). REITs include in TN net earnings (eligible for DPD) and also deduct per foreign-source DRD.

2019 Federal Tax Reform Conformity/Decoupling Developments

Virginia

H.B. 2529, enacted Feb. 15, 2019

- Updates Virginia's general IRC conformity date. As a result, VA conforms to the IRC "as [the IRC] existed on December 31, 2018, retroactively effective to January 1, 2018. As a result, Virginia now conforms to most, but not all, of the federal tax reform amendments enacted as the Tax Cuts and Jobs Act. 2018 legislation only updated conformity to TCJA amendments that were effective for the 2017 tax year.
- In addition, H.B. 2529 provides a deduction for GILTI income. In Tax Bulletin 19-1, the Department of Taxation explained that Virginia's GILTI income deduction is of the "net inclusion of GILTI" (i.e., GILTI income under IRC Section 951A less the amount of the corresponding GILTI deduction of IRC Section 250(a)(1)(B)).

Other State Tax Issues and Considerations

Other state taxation issues – United States Constitutional Issues

Complete Auto Four-Part Test—first three prongs primary means to challenge state tax treatment of international transactions or operations

-*Substantial nexus*:

-Unitary vs. Non-Unitary CFCs

-*Non-discrimination* against inter- or intra-state activities

-Facial vs. as-applied discrimination

-Discrimination against U.S. activities?

-*Fair apportionment*

-Potential issues rampant

-Difficult burden to show “gross distortion”

Other state taxation issues – United States Constitutional Issues

- Are RTT or GILTI constitutionally apportionable income?
 - State must have jurisdiction to tax (i.e., nexus) income.
 - Was U.S. shareholder engaged in unitary business with foreign subsidiary (CFC)?
 - State long-arm statutes: limit the reach of state taxation as much or more than the Constitution
- Even if a U.S. shareholder and foreign subsidiary are conducting a “unitary business,” taxation must be nondiscriminatory and fairly apportioned.
 - Nondiscrimination and fair apportionment are related but distinct prongs

Other state taxation issues – United States Constitutional Issues

- In *Mobil Oil Corp. v. Comm's of Taxes of Vt.*, 445 U.S. 425, 439 (1980), the Supreme Court held that the “linchpin of apportionability in the field of state income taxation is the unitary-business principle.”
- Therefore, where a U.S. shareholder is not domiciled in a state that includes GILTI in its corporate income tax base, the U.S. shareholder must have been engaged in a unitary business with its CFC or the CFC must have served an “operational function” in the U.S. shareholder’s business for GILTI to be includable in the apportionable tax base.
 - Even if domiciliary, cannot discriminate against domestic (i.e., domiciled in-state) taxpayer (*See Wynne*).
 - Must show “engaged in business” across state or international lines.

Other state taxation issues – United States Constitutional Issues

- Discrimination against foreign commerce
 - Disparate treatment of foreign and domestic subsidiaries?
 - *Kraft General Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992)
- Are RTT and GILTI fairly apportioned?
 - If jurisdiction exists, income must be fairly apportioned. Some recognition must be given in apportionment formula to income-generating factors.
 - Internal consistency: Does universal application result in multiple taxation?
 - May be used to show facial discrimination under the discrimination prong.
 - External consistency: Do factor or factors used in apportionment formula reasonably reflect how income is generated?
 - The external consistency test is very fact-specific, but there is potential to show RTT or GILTI problems based on apportioning income from foreign operations based on different operations in the state or the United States (e.g., MD, NJ).
 - Distortion caused by “net income” or “net receipts” versus “gross receipts” in receipts factor apportionment

Other state taxation issues – United States Constitutional Issues

- *Kraft General Foods Inc. v. Iowa Dep't. of Rev.*, 505 U.S. 71 (1992)
 - Federal conformity is not a rational basis for facial discrimination in separate company reporting states
 - Different result in combined reporting states?
- A state's taxation of GILTI could potentially violate the Foreign Commerce Clause
- Separate Return States
 - Domestic subsidiaries that generate income analogous to GILTI are not taxed whereas foreign subsidiaries generating GILTI are taxed
- Combined Reporting States
 - No allocation of foreign subsidiaries attributes (e.g., if foreign subsidiary had a net loss) despite inclusion of GILTI in the U.S. shareholder's apportionable tax base

Other state taxation issues – United States Constitutional Issues

- What is GILTI?
 - “Tax Haven” vs. “Base Protection”
 - GILTI much more tax haven legislation than base protection legislation
 - Beware presumptuous state guidance

- What is FDII?
 - Incentive to produce in the U.S. to serve foreign markets
 - DISCs for services—but not quite as lenient
 - Inherently discriminatory? – State tax authorities in states that conform to federal special deductions may try to deny deduction based on inherent discrimination.
 - What is the appropriate remedy? Argue to permit deduction for inter or intra-state services?
 - Potential to exclude RTT or GILTI if state attempts to deny the deduction.
 - Foreign taxpayers with inbound activities – entitled to similar deduction?
 - Discrimination in favor of outbound vs. inbound activities.

Thank You

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