

Income Tax – TCJA and Other SALT Matters

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Agenda

- Federal Tax Changes Rocking the SALT Landscape
 - Repatriation Transition Tax
 - Global Intangible Low Tax Income
 - Foreign Derived Income Inclusion
 - Cost Recovery
 - Interest Expense Deduction Limitation
- California Office of Tax Appeals
- Apportionment – Market Sourcing & Alternative Apportionment
- Combined Reporting
- Taxable Income – Discretionary Adjustment

SALT Impact of TJCA Provisions

General Overview

- The state tax impact of TCJA provisions is conformity dependent
 - Floating conformity
 - Static conformity – fixed, annual update,
- Filing methodology will impact the application of TCJA
 - Definition of state taxable income (world-wide v. federal taxable income)
 - Separate v. combined filing method
 - Composition of combined group filing
 - Application of state combination provisions
 - Application of the federal consolidated return rules

Repatriation Transition Tax

Transition Tax – IRC Sec. § 965

- General concepts:
 - One time tax on untaxed foreign earnings of certain foreign subsidiaries (accumulated post-1986); deemed repatriation
 - Included in Taxpayer's gross income as Subpart F income
 - Potential foreign commerce clause issues (Kraft)
- Repatriation
 - Mitigated to extent of state's DRD
 - Factor representation/distortion
 - Character of income
 - Previous taxation of income
 - World-Wide Combined Reporting
 - Taxation of world-wide income
 - Taxation of effectively connected income without treaty exemptions

Transition Tax – IRC § 965 (cont'd)

- States responses:
 - Included in Income After Deduction (IRC § 965(a) inclusion and IRC § 965(c) deduction).
 - Included in Income Without Deduction (IRC § 965(a) inclusion without IRC § 965(c) deduction)
 - Excluded from Income
 - Installment payments allowed vs. not allowed
- Most Recent Developments
 - OR tax haven credit (10/12/18)
 - ME (9/12/18) – 20% of 965 income taxable; 50% amount of GILTI pre-apportionment
 - NJ (10/5/18) – No 965 conformity but 965 income taxable with 95% DRD; surtax

FEDERAL TAX REFORM

- California – A Selective Conformity State
 - No automatic conformity to changes made to the Internal Revenue Code (IRC)
 - Currently, California conforms to the IRC as of January 1, 2015
- Deemed Repatriation
 - No current conformity to IRC § 965
 - For water's edge purposes, Subpart F income means "Subpart F income as defined in IRC § 952"
 - Inclusion ratio numerator not affected by IRC § 965 amendments
- Actual Repatriation
 - No conformity to IRC § 245A
 - Dividend deductions depend on whether filing on a worldwide or water's edge basis
 - Full elimination of unitary dividends under Revenue and Taxation Code (RTC) § 25106
 - 75% deduction under RTC § 24411
 - Foreign investment interest offset under RTC § 24344
 - Inclusion ratio issues with respect to Subpart F income

Global Intangible Low Tax Income IRC §§ 951A, 250

Global Intangible Low Taxed Income and Foreign Derived Intangible Income – IRC §§ 951A, 250

- “GILTI” – Name is a misnomer – targeted at all low taxed income outside the US, from intangibles or otherwise
- General Concepts:
 - Basically the prospective application of the Repatriation Transition Tax (IRC § 965).
 - IRC § 951A resides in Subpart F of the Code, but is not Subpart F Income as defined in the code.
 - IRC § 951A states that the GILTI is to be treated like it was Subpart F Income defined in IRC § 952.
 - State conformity may not necessarily conform to the IRC § 951A directive to treat GILTI the same as Subpart F income defined in IRC § 952
- GILTI is reduced by 50% pursuant to IRC § 250

Global Intangible Low Taxed Income and Foreign Derived Intangible Income – IRC §§ 951A, 250

State Tax Implications

- Theoretically inconsistent with formulary apportionment
 - Territorial tax systems allocate income versus apportioning income by formula
- Conformity
 - More or less expansive definition of federal taxable income
 - Federal consolidated return rules will cause filing method inconsistency
 - Worldwide group filers will have already included such income
- Proper calculation of GILTI for state tax purposes
 - Inclusion of GILTI in state taxable income (DRDs, subpart F treatment)
 - Inclusion of IRC § 250 deduction to effect rate reduction
- Apportionment
 - GILTI inclusion may create dilution of the apportion factors
 - Addition of foreign factors to the denominator, no correlative numerator increase
 - Application of IRC § 250 deduction ensures dilution
- State Reaction – statutory proposals to exclude GILTI (NJ)

Cost Recovery – Immediate Expensing IRC § 168(k)

Immediate Expensing – IRC § 168(k)

Federal Tax Treatment

- Immediate Expensing of business expenses accelerates basis reduction
- IRC § 168(k) expanded to include full expensing of cost of new and used qualified property between 9.27.17 and 1.1.23

State Tax Treatment

- Most states do not conform to immediate expensing
- Significant basis differences on all property results from decomformity
- Every transactions must be reviewed for state tax purposes
- Decoupling from accelerated, bonus and full cost recovery has created significant differences between state and federal basis.
 - State basis will always be better than federal basis
 - Independent analysis is critical to reducing the gain on transactions

Interest Expense Deduction Limitation

IRC § 163(j)

Interest Limitation – IRC § 163(j)

Federal Tax Treatment

- Limits deductibility of interest expense to 30% of adjusted taxable income
- Proposed regulations provide that the limitation applies at the consolidated group level
- Does not deem the interest expense not paid (recipient still has income)
- Carryforward of non-deductible interest expense

State Tax Issues

- Conformity (NY conforms; CA does not)
- Calculation of the interest expense limitation (filing methodology)
 - Multiple state groups will create double taxation of income
- Impact on related party addback provisions
 - Deductibility – Is it still an “otherwise deductible interest expense”
 - Exceptions – How do you calculate the exceptions to the addback?

Interest Limitation – IRC § 163(j)

State Tax Issues

- Interest Expense Limitation
 - New York has rolling conformity to current IRC § 163(j)
 - California conforms to prior version of IRC § 163(j)
 - No automatic conformity to amendments to IRC § 163(j)
 - Compare RTC § 25116
 - California has two expense attribution type statutes that are applied to limit interest deductions
 - RTC § 24425 – expenses disallowed where they were incurred for the primary purpose of providing non- taxable income
 - RTC § 24344 – foreign investment interest offset – interest expense incurred for the purposes of foreign investment may be disallowed
 - New York also employs expense attribution provisions

California Office of Tax Appeals



TAX ADMINISTRATION REFORM

- Taxpayer Transparency and Fairness Act of 2017 (AB102)
 - Enacted on June 27, 2017
 - Eliminated SBE's authority to administer most taxes and to adjudicate most tax appeals, including tax appeals for corporate income and franchise tax, personal income tax and sales and use tax
 - SBE continues to administer and hear all tax appeals only for property, insurance and alcoholic beverage taxes
 - On July 1, 2017, the newly created CDTFA began administering sales and other excise taxes
 - On January 1, 2018, tax appeals for income and sales and use taxes began being heard by the newly created Office of Tax Appeals (OTA)
 - Cases heard by panels of three administrative law judges (ALJs)
 - ALJs designated by the director of the OTA, who is appointed by Governor
 - Tax appeals panels required to issue written opinions in all appeals
 - Hearings are generally required to be conducted under the Administrative Procedures Act
 - Regulations have been proposed setting forth the procedural rules for appeals

Apportionment

APPORTIONMENT/SOURCING OF SALES

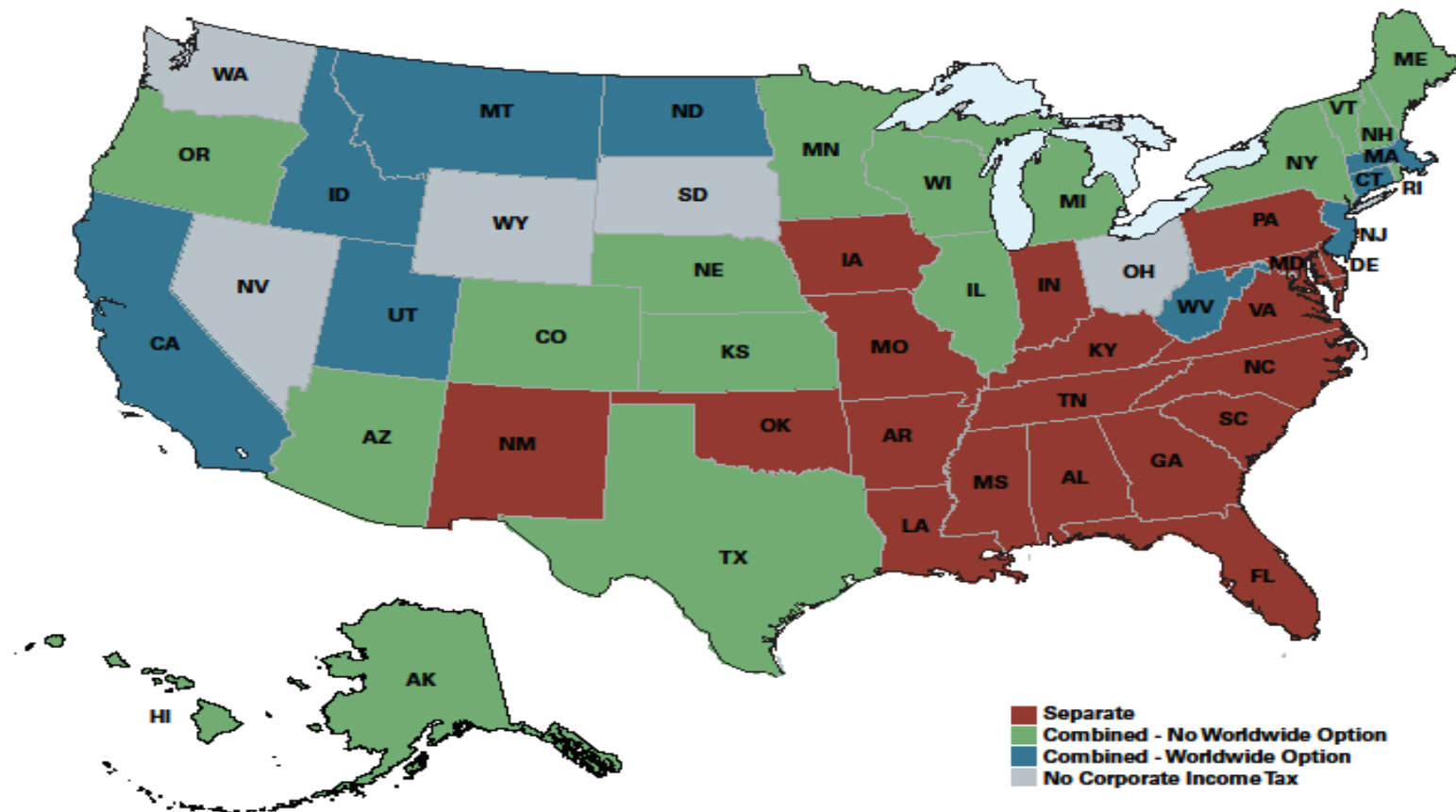
- Market-based sourcing of sales of services and intangibles
 - Required for tax years beginning on or after January 1, 2011
 - Regulation 25136-2 contains elaborate set of cascading rules
 - Services sourced to the state where purchaser receives the benefit of the services
 - Intangibles sourced to the state where the intangible property is used
 - Sales factor provisions of Regulations 25137-25137-14 (including Regulation 25137-4.2) are incorporated to reflect market-based sourcing
 - No throwback required
- Additional issues being addressed in the regulatory process
 - Second set of amendments have been proposed

Trends in Alternative Apportionment / §482-Type Adjustments

- California FTB is currently undergoing rulemaking process for alternative apportionment petitions.
 - Focuses on appeals to the FTB three-member board after FTB staff denies a 25137 petition.
 - Adds a provision allowing the FTB three-member board to elect to hear an initial 25137 petition.
 - Fails to fix the lack of confidentiality provided to taxpayers in front of the three-member board.
 - Interested Parties Meeting held November 26, 2018 to consider potential amendments to Regulation 25137 pertaining to hearings before the 3-member FTB on RTC § 25137 Petitions
 - Taxpayers and their representatives are now permitted to make oral presentations before the FTB 25137 Committee in support of petitions for relief and in opposition to staff's request
 - FTB Notices 2017-05 and 2018-02

Combined Reporting

Combined Reporting v. Separate Reporting States



Note: Elective, industry-specific, and like provisions are not taken into consideration. This map is intended to represent general filing methods.

New Jersey Tax Reform

- New Jersey A. 4495, signed into law on October 4, 2018, amends the state's Corporation Business Tax law
 - Many changes are technical corrections in response to the tax reform legislation (A.B. 4202), enacted on July 1, 2018
- Law addresses: (1) TCJA; (2) Combined reporting; (3) Market-based sourcing; (4) Surtax on corporation.
- Effective January 1, 2018, NJ taxes GILTI (IRC §951A).
 - NJ coupled to the federal treatment of GILTI and the FDII deduction.
 - Open question → Apportionment *i.e.*, how much GILTI is subject to NJ taxation.
- Effective for TYE on or after July 31, 2019, NJ adopts combined reporting and market-based sourcing.
 - Require members of unitary business groups to file water's-edge combined reports (with election to file using worldwide income)
- Trend towards combined reporting continues

COMBINED REPORTING

- *Harley Davidson, Inc. v. FTB*, 27 Cal.App.5th 245 (2018)
 - Case involves issue whether FTB improperly discriminates against multistate unitary corporate taxpayers by requiring combined reporting and not allowing them to choose separate reporting
 - Court of Appeal held that since there is a legitimate state interest to accurately measure and tax all income, California can require interstate unitary businesses to use combined reporting
- Excess Inclusion
 - FTB Legal Ruling 2009-01 addressed how excess inclusion is determined for a Non-Economic Residual Interest Holder (NERI) in a Real Estate Mortgage Investment Conduit (REMIC) in a combined report
 - FTB Information Letter 2009-01 addressed the application of the excess inclusion rules to non-NERI members of a combined report
 - FTB Technical Advice Memorandum 2018-02 concluded that excess inclusion pertaining to all the NERIs in a combined report is aggregated and thereafter apportioned to each NERI using the NERI's California apportionment percentage

Business/Nonbusiness Income

BUSINESS / NONBUSINESS INCOME

- *ComCon Production Services v. FTB*, Court of Appeal No. B259619, 2016 Cal. App. Unpub. LEXIS 9078 (2016)
 - Trial court held that termination fee received in connection with a failed merger was business income
 - Trial court also held that Comcast and QVC were not engaged in a unitary business
 - Court of Appeal affirmed in unpublished opinion

BUSINESS / NONBUSINESS INCOME

- *Fidelity National Information Services v. FTB*, No. C081522, 2017 Cal. App. Unpub. LEXIS 5148 (2017)
 - Sale of minority stock interest
 - Trial court held the gain was business income
 - In an unpublished opinion, Court of Appeal reversed and remanded case back to the trial court to determine whether the stock was a business asset when decision was made to sell it
 - On remand, trial court again found the gain to be business income
 - After appeal filed, case was dismissed in 2018

BUSINESS / NONBUSINESS INCOME

- *Bank of America Corp.*, SBE Case No. 983272 (2017)
 - On November 14, 2017, the SBE held that dividends received by the Bank from one of its Chinese affiliates was nonbusiness income because of lack of integration and interwoven ties between the affiliates
 - FTB filed petition for rehearing
- *Levi Strauss*, SBE Case No. 54705 (2013)
 - SBE appeal involving issue whether interest and other expenses incurred in connection with a leveraged buy out of a California corporation's stock were nonbusiness expenses wholly allocable to California
 - Case settled prior to the SBE hearing
- *Esprit de Corp.*, SBE Case No. 48986 (2001)
 - SBE held that LBO interest expense was a nonbusiness expense wholly allowable to California

BUSINESS / NONBUSINESS INCOME

- *Leslie's Holdings, Inc.*, SBE Case No. 955278 (2017)
 - On November 15, 2017, the SBE held that 84 percent of interest expense incurred as a result of borrowing to conduct a corporate reorganization was a nonbusiness expense allocated the taxpayer's commercial domicile in Arizona
 - Remaining 16 percent was held to be an apportionable business expense because it was attributable to borrowing to make distributions to employees

Discretionary Authority

Trends §482-Type Adjustments

- *Utah State Tax Commission v. See's Candies, Inc.*
 - The Utah Supreme Court affirmed the trial court's decision to seek interpretive guidance from IRC 482 and the accompanying federal regulations and to employ the federal arm's-length transaction standard in determining whether See's income was clearly reflected on its returns.

City Tax Development

CITY TAXES

- San Francisco Business Tax
 - Combination of Payroll Expense Tax and a Gross Receipts Tax
 - Worldwide/water's edge unitary tax at local level
 - Proposition C
 - Passed November 6, 2018
 - Would levy an additional gross receipts tax on corporate revenues greater than \$50 million to fund homelessness
 - May be subject to challenge since did not obtain 2/3 voter approval
- Head Taxes
 - City of Cupertino proposed an employee “head tax “ patterned after the Seattle head tax – aimed at Apple
 - City Council decided on July 31, 2018, to wait until 2020 before putting the tax proposal before voters
 - On November 6, 2018, the voters of the City of Mountain View passed a “head tax” to fund transportation issues – aimed at Google

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