State and local tax roundup

Global investor edition

September 2017

Insights exploring state and local tax issues affecting global investors in the United States

Highlights

- *Multistate US tax issues for inbounds*
- *In defense of water's edge reporting*
- *State and local tax considerations around acquisitions and dispositions*
- *Impact of proposed Section 385 regulations*
- *Tax havens*
- *Notable developments from Arkansas, Colorado, Massachusetts, Minnesota, Oregon, and Washington*

Thought leadership

Multistate US tax issues for inbound companies

Non-US companies with activity in the US are often surprised that such activity may trigger both federal and state-level tax implications. Even more surprising is that state tax exposure may vary substantially, potentially resulting in significant state tax liabilities when little to no US federal tax obligations exist.

Non-US companies may not be used to dealing with tax authorities within a country that have such broad taxing powers. For example, states are not always restricted in their taxing powers by federal limitations such as engaging in a trade or business, having a permanent establishment (PE), or treaty restrictions. States are also not always bound by uniform tax laws; each state may implement unique tax rules, making compliance difficult for foreign companies.

There are several aspects of state taxation that are critical for owners of non-US companies to understand, including a state's power to tax, income apportionment, state filing methodologies, tax starting point issues, treatment of foreign source income, transfer pricing adjustment considerations, registration requirements, and indirect taxes.

Access our full article.

In defense of water's edge reporting: state and local tax for global investors

State tax authorities are increasingly focusing on and reviewing multinational taxpayers. For example, several states have enacted legislation to provide exceptions to their water's-edge reporting rules to include in a water's-edge return the income of non-US entities doing business or incorporated in so-called tax havens. The trend of expanding the unitary group to include entities doing business or incorporated in tax havens is similar to previous calls by states for mandatory worldwide reporting to subject an affiliated group's global income to a state's formulary apportionment. Those efforts are unnecessary because states already have income and apportionment adjustment tools that can be used to address any perceived tax avoidance.

They also risk casting a wide net over all taxpayers with foreign activity. Further, state lawmakers are not considering the potential unintended consequences of those efforts, which could result in an overall reduction of state revenue.

Whether one agrees or disagrees with the legislative, regulatory, and administrative approaches states have taken recently, states and their revenue agencies have many powers they can use to target perceived tax avoidance. Given the tools available, there is no need for states to apply broad provisions such as worldwide combined reporting and tax haven legislation that could harm taxpayers engaged in multinational activity while providing no guarantee of increased state tax revenue.

Read our full article.

Notable state and local tax considerations associated with corporate acquisitions and dispositions

Business acquisitions and dispositions often give rise to exceedingly complex tax considerations, including a wide-range of state and local taxes, such as income and franchise taxes, sales and use taxes, and property taxes, among others. These state and local tax issues should be addressed when a transaction is first being contemplated, and throughout the life of the deal, including during post-deal integration. Properly addressing these issues in real-time may help businesses avoid compliance problems in the future.

There are a myriad of complex state and local tax issues that may arise in the context of acquisitions and dispositions, including state basis differences, classification of income, sales factor inclusion, and sourcing of income. There also are different types of taxes that may apply. Potentially significant tax liabilities make such state tax issues important to consider.

Access our full article.

State tax considerations for Section 385 exceptions

On October 13, 2016, the US Treasury Department released final and temporary regulations under IRC section 385, making significant changes to the proposed regulations released on April 4, 2016. The section 385 regulations apply to covered debt instruments issued after April 4, 2016, by domestic corporations that are members of an expanded group and address whether such debt instruments between related parties will be treated as debt or equity in a distribution, exchange for expanded group stock or exchange for property in an asset reorganization. The section 385 regulations impose documentation requirements on debt instruments that include long-term inbound and domestic lending when the lender and borrower are not members of the same federal consolidated group, short-term funding and cash pooling, and general intercompany payables

Despite Treasury's adoption of suggested changes, the section 385 regulations still have unintended state tax implications and cause significant uncertainty for state taxpayers. A lack of explicit guidance from states regarding their conformity to the regulations and the one-corporation exception will likely result in increased administrative burdens and compliance costs. In its current form, the one-corporation exception might not apply in separate company reporting states that do not permit filing consolidated returns under the federal consolidated group election, in combined states that do not adopt the federal consolidated return regulations, or in circumstances in which the membership in a unitary combined group is different from that of the federal consolidated group.

Read our full article.

Notable developments

Minnesota Supreme Court - Disregarded foreign entity included in domestic owner's combined group for pre-2013 years

On August 2, 2017, the Minnesota Supreme Court found that the income and apportionment factors of a disregarded foreign entity could be included in the income and apportionment factors of its wholly owned-unitary domestic US corporation. By electing to be a disregarded entity, a foreign entity is deemed to have distributed its assets and liabilities to its sole shareholder in liquidation of the association. Because a foreign entity is deemed no longer to exist for income tax purposes, its income and apportionment factors are deemed to be a part of its domestic sole shareholder and therefore could be included in the shareholder's Minnesota combined return.

The court disagreed that the 2006 Minnesota Supreme Court Manpower decision was controlling. Furthermore, the court declined to defer to the Commissioner's longstanding policy contained in Revenue Notice 98-08 that would have excluded the income and apportionment factors of the foreign disregarded entity from the combined group.

This decision relates to the 2009 to 2011 tax years, during which the income and apportionment factors of a 'foreign corporation' or 'other foreign entity' could not be included in a unitary return. Starting in tax year 2013, the income and apportionment factors of a disregarded foreign entity that are included in the federal taxable income of a domestic corporation must be included in the net income and apportionment factors of the unitary business.

Read our *Tax Insights.*

Massachusetts – Draft guidance provides treaty-protected income excluded from non-income tax measure's apportionment formula; open questions remain

On June 22, 2017, the Massachusetts Department of Revenue released a working draft Technical Information Release (TIR) providing that a non-US combined group member will exclude from its non-income excise tax apportionment percentage any amounts that are attributable to treaty-exempt income.

If finalized, the TIR would reverse guidance provided in a 2011 TIR. Such treatment would be applicable going forward and for all open tax years.

Read our *Tax Insights.*

Tax havens

2016 developments

There have been many state legislative proposals that impact international business organizations doing business in the United States. Various forms of tax haven laws have been enacted in Alaska, DC, Montana, Rhode Island, Oregon, and West Virginia.

In 2015 Connecticut enacted and then modified a new tax haven law, Oregon broadened its tax haven laws, and DC modified the blacklist in its existing tax haven law.

The 2016 legislative session was very active, with Alabama, Colorado, Kansas, Kentucky, Louisiana, Maine, and New Jersey introducing new tax haven bills.

Read our *Tax Insights.*

2017 legislative tracker

You can access our tax haven tracker for the current status of state tax haven bills.

We will update this tracker on a regular basis to provide current information regarding these and other legislative proposals.

Oregon allows unitary group to be determined by reference to foreign entities

Applicable to tax years beginning on or after January 1, 2018, whether two or more corporations that are included in the same consolidated federal return are engaged in a unitary business may be determined by making reference to "any corporation that is owned or controlled directly or indirectly by the same interests."

Prior to this law change, generally only corporations subject to federal income taxation (e.g., not foreign organized entities) could be considered to determine an Oregon unitary group.

[Oregon S.B. 30, signed May 30, 2017]

Arkansas does not apply US-Canada income tax treaty to state income tax

The Arkansas Department of Finance and Administration issued a legal opinion addressing the applicability of the US-Canada Income Tax Treaty to Arkansas personal income tax. The Department determined that the treaty applies only to US federal income taxes, such that "income taxes levied by individual states, such as Arkansas, do not fall within the treaty's jurisdiction." As a result, "the treaty's provisions are generally not recognized by this state."

While this decision applies to personal income tax, it may offer some insight into how the Department would treat a similar situation of corporate income tax.

[Arkansas Department of Finance and Administration, Legal Opinion No. 20170217, March 13, 2017]

Massachusetts Department of Revenue issues guidance on the excise tax treatment of offshore investment companies

In a Technical Information Release (TIR) issued on February 16, 2017, the Department of Revenue updated Massachusetts guidance to reflect changes made to the Internal Revenue Code in 1997, which expanded the administrative activities that offshore investment companies could engage in within the US without the creation of effectively connected income (ECI) subject to federal income tax. The federal changes removed the 'principal office' limitation from the statute and the list of safe harbor activities listed in Treas. Reg. § 1.864-2, which dictated the limited administrative functions that offshore investment companies could perform in the US without the creation of ECI.

The guidance released by Massachusetts provides a safe harbor list of activities similar to the prior Treasury Regulations that can be carried on without subjecting the offshore investment company to excise tax. However, the TIR also provides a list of activities, such as maintaining principal records and books of account, maintaining a place of business, or executing contracts within the state, which will subject the offshore company to Massachusetts excise tax.

[Massachusetts Department of Revenue, Technical Information Release No. 17-2 (2/16/2017)]

Colorado - receipt of royalties from an in-state franchisor creates nexus due to 'factor presence'

On May 3, 2016 the Colorado Department of Revenue issued a General Information Letter, which concluded that a receipt of royalties from an in-state franchisor will create nexus in a state with 'factor presence.'

A C-corporation that is a franchisor, located outside of Colorado, sells franchises that sell products that clean cooking oils in restaurants and other commercial cooking facilities. The franchisor does not have any payroll or property in Colorado.

The franchise agreement includes contractual rights and licenses to use the franchisor's trademark and tradename. Because the trademark and tradename are used by the franchisee in Colorado, the Department concluded that payments received from franchisees should be included in determining whether the franchisor exceeds Colorado's factor presence nexus threshold of $500,000 during the taxable period.

[Colorado Department of Revenue, GIL 16-004, May 3, 2016]

Colorado trial court – Economic nexus for IP company; alternative apportionment must include the IP company's property and payroll

On January 27, 2017, a Colorado trial court found that an intangible property company with no physical presence in the state was subject to Colorado's corporate income tax.

On audit, the Colorado Department of Revenue required the intangible property company to apportion its income based on the sales factor of its parent company. The trial court found that this alternative method was unreasonable because it failed to consider the significant contributions made by the intangible property company's payroll and property outside Colorado to the value the Department sought to tax.

Furthermore, the court found that any alternative apportionment formula must include the intangible property company's property and payroll. The ultimate decision did not describe an acceptable apportionment formula. The court ordered the parties to confer regarding the proper recalculation of the assessments and report back to the court, after which the court would enter a final judgment.

[*Target Brands, Inc. v. Department of Revenue of the State of Colorado*, District Court, City and County of Denver, No. 2015CV33831 (1/27/17)]

Read our *Tax Insights.*

Washington – Receiving royalties creates nexus; US treaty does not generally protect against state taxation

A Washington Tax Review Officer (Officer) ruled that a German pharmaceutical company had economic nexus in the state due to its receipt of royalties paid when its products were sold in Washington, even though the business had no physical presence in the state.

The Officer also determined that a tax treaty between the United States and Germany implicitly permits states to tax royalties. Although the treaty would protect against discrimination created by the B&O tax, the Officer found no prohibited discrimination occurred here. Under the treaty, the company may avoid double taxation by excluding from its German tax base gross income taxed by Washington.

Taxpayer raised the constitutionality of Washington's economic nexus standard. However, the Appeals Division lacks the authority to rule on the constitutionality of statutes. Accordingly, it remains to be determined whether a higher court will address the Commerce and Due Process clause issues. This decision highlights a common misunderstanding of how US tax treaties impact state taxation. US tax treaties generally do not contain protection against state taxes. As noted by the Officer, the US-Germany treaty generally applies to federal US taxation and, therefore, 'implicitly' permits taxation of royalties by Washington.

Under the US-Germany treaty, the general application to only federal taxes is relaxed for purposes of preventing discrimination, which is prohibited for taxes imposed by a 'local authority' of the US. Taxpayers should take care in reviewing tax treaties that may apply to their state tax footprint. Although treaties may not generally apply to state taxes, some states may voluntarily accept provisions of certain treaties. Additionally, like the nondiscrimination clause in the US-Germany treaty, there could be some treaty protections that may apply to state taxes.

Washington Department of Revenue Appeals Division, Det. No. 15-0251, 35 WTD 230 (decided 9/11/15, published 5/31/16)]

Read our *Tax Insights.*

Let's talk

For a deeper discussion, please contact:

Chris Kong

US Inbound Tax Leader

+1 (416) 869-8739

christopher.p.kong@pwc.com

Todd Roberts

US State and Local Tax Inbound Leader

+1 (720) 931-7222

todd.roberts@pwc.com