



Effects of Bringing Foreign Entities into a Combined Return

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Agenda

- ◆ **Selected State Treatment of Foreign Entities**
- ◆ **Selected Topics in Combined Reporting**
- ◆ **Inclusion of Foreign Entities in Unitary Group**
- ◆ **Exclusion of Foreign Entities from the Unitary Group**



Selected State Treatment of Foreign Entities



California

Water's Edge Election Method

◆ California's Taxation of Worldwide Income and the Water's Edge Election

- Taxpayers generally will be taxable on the worldwide income of the unitary business. Cal. Rev. & Tax. Code § 25101.
- However, a taxpayer may elect to determine its taxable income by taking into account only domestic entities, certain foreign entities and certain other income. Cal. Rev. & Tax. Code § 25110.
- As discussed below, California has special rules for certain foreign entities such as Controlled Foreign Corporations (CFCs) and foreign entities with 20 percent or greater apportionment in the United States.

California Treatment of CFCs

◆ Income of a CFC that is Includable in a Water's Edge Combined Report

- Existing law requires inclusion in a water's-edge combined report of "Subpart F" income of a CFC (as defined in 26 U.S.C. § 957), regardless of whether the foreign corporation is a California taxpayer. See Cal. Rev. & Tax. Code § 25110(a).
- To determine the portion of a CFC's Subpart F income that will be included in the water's-edge report, Cal. Rev. & Tax. § 25110(a)(2) creates an "inclusion ratio." Specifically, the CFC's net income is multiplied by a ratio of its subpart F income for the taxable year to its earnings and profits ("E&P") for the taxable year to arrive at the amount of CFC income that will be included in the Combined Report.

California Treatment of CFCs (cont.)

◆ Exclusion of Certain CFC Subpart F Income by Cal. Rev. & Tax Code § 25110(d)(2)(E)(3).

- A CFC must be included in the water's edge report to the extent of the inclusion ratio. However Cal. Rev. & Tax Code § 25110(d)(2)(E)(3) incorporates certain exclusions and exemptions contained in 26 U.S.C. § 954(b).
- Due to the incorporation of these exclusions, a taxpayer may exclude Subpart F income from the inclusion ratio if it qualifies as “high foreign tax income” under 26 U.S.C. § 954(b)(4). Income will qualify as high foreign tax income if the taxpayer establishes that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in 26 U.S.C. § 11.

Inclusion of Other Entities and Income

- ◆ Any corporation whether organized in the United States or a foreign country, if the average of its property, payroll and sales factors within the United States is 20 percent or more.
- ◆ Treatment of effectively-connected income.

Elimination of “Qualifying Dividends”

◆ Dividend Deduction Requirements for Certain Intercompany Dividends

- For water’s edge election taxpayers, the partial deduction of intercompany dividends is only allowed to the extent such dividends are “qualifying dividends”.
- Under Cal. Rev. & Tax Code § 24411(a), “qualifying dividends” means those received by the water's-edge group from corporations if both of the following conditions are satisfied:
 - The average of the property, payroll, and sales factors within the United States for the corporation is less than 20%, and
 - More than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by the water's-edge group.

California Case Law on Combined Reporting

◆ *Apple Inc. v. FTB*, San Francisco Superior Court No. CGC-08-471129 (January 26, 2010) (currently on appeal).

- The California Franchise Tax Board (FTB) denied certain interest deductions taken by Apple, arguing that such interest deduction cannot be allowed under Cal. Rev. & Tax Code § 24425, which denies interest expenses if allocable to untaxed income.
- The Superior Court of San Francisco concluded otherwise, holding the taxpayer adequately proved that Apple's interest expenses were allocable to its taxed domestic earnings and not the untaxed dividends Apple received from its foreign subsidiaries.
- Also addresses elimination of dividends received from entities outside the water's-edge group.
- The case is currently on appeal in California's First Appellate District.
- See also *Fujitsu IT Holdings, Inc. v. FTB*, 120 Cal App. 4th 459 (2004).

The Effect of Dividend Repatriation under 26 U.S.C. § 965 in California

- ◆ The 2004 American Jobs Act temporarily made cash dividends received by a U.S. corporation from controlled foreign corporations eligible for an 85% dividends-received deduction, pursuant to 26 U.S.C. § 965. (“§ 965”) on certain extraordinary dividends to be used for domestic reinvestment.
- ◆ If the payor is unitary with the payee and included in the water's-edge combined report, the dividend will be eliminated to the extent it is paid out of unitary earnings. (Cal. Rev. & Tax Code § 25106) . However, if the payor is outside the water's edge group, a 75 percent dividends-received deduction under Cal. Rev. & Tax Code § 24411 should apply.
- ◆ Potential refund claims



Illinois

Water's Edge Default Rule

- ◆ Illinois employs the water's-edge method of combined reporting for each unitary group of taxpayers. However, the use of worldwide combined reporting is constitutionally permissible in Illinois.
- ◆ Under the water's-edge method the unitary business includes only U.S.-sourced income in apportioning its income and computing its tax.

Treatment of “80/20 Companies”

- ◆ The unitary group will not include members for whom 80% or more of their business activity is conducted outside the United States. See 35 ILCS § 5/1501(a)(27).
- ◆ “United States” means only the 50 states and the District of Columbia, but does not include any territory or possession of the United States or any area over which the United States has asserted jurisdiction or claimed exclusive rights with respect to the exploration for or exploitation of natural resources. *Id.*

Treatment of “80/20 Companies” (Cont.)

- ◆ Business activity within the United States shall be measured by the factors ordinarily applicable under subsections (a), (b), (c), (d), or (h) of 35 ILCS § 5/304. (i.e. the Illinois apportionment factors). Thus, if 20% or less income is apportioned to Illinois, the member can be excluded.
- ◆ In the case of members ordinarily required to apportion business income by means of the three factor formula of property, payroll and sales, such members shall not use the sales factor in the computation and the results of the property and payroll factor computations shall be divided by 2 (by one if either the property or payroll factor has a denominator of zero).

Treatment of “80/20 Companies” (Cont.)

◆ Addition to Base Income Of the Combined Group:

- Pursuant to 35 ILCS § 5/203(b)(2)(D-17), base income includes amounts that would otherwise be deducted for interest paid to a foreign person, who would be a member of the same unitary business group but for the fact that more than 80% of its business activity is conducted outside the United States.
- Thus, Illinois denies the deductibility of interest paid to related corporations that have been excluded from the group solely because less than 20% of their business activity is conducted in the United States.



Massachusetts

Water's Edge Method

- ◆ **Each taxable member determines its share of combined group income on a water's-edge basis by taking into account the income/apportionment data of:**
 - The taxable members of the combined group, and
 - The non-taxable members of the combined group that fall within one of three categories

Non-Taxable Member Categories

◆ There are three categories of non-taxable members within the water's edge group

- Corporations organized within the United States
- 80/20 Corporations
- More than 20% Income Inclusion Corporations

More Than 20% Income Inclusion Corporations

- ◆ Definition: Any member that earns 20 percent or more of its gross income, directly or indirectly, from intangible property or service related activities, the costs of which are deductible for federal income tax purposes against the business income of the other members of the group
- ◆ Types of Income include royalty income, income from the license of trademarks, patents or other intellectual property, interest and other income from lending money and income from management services

More Than 20% Income Inclusion Corporations

- ◆ A corporation so included in the water's-edge group is included only to the extent of the intercompany income and related apportionment factors that produced such income
 - Income to be included includes such gross income derived from the intercompany payments as reduced by the deduction of any expenses that are reasonably related and not disproportionate to such income, but gross income may not be reduced below zero
 - Property/payroll of the member that produced the gross income is included in the combined group's apportionment computation to the extent that such property/payroll produced such income

More Than 20% Income Inclusion Corporations: Practical Implications

- ◆ A non-U.S. corporation may have no physical presence in the United States and may have no requirement to file a federal income tax return, but will be required to join the Massachusetts water's edge group
- ◆ Intercompany expenses that previously were deducted for Massachusetts purposes are now eliminated.
 - If the 20% threshold is not exceeded, the intercompany payment may be subject to the Massachusetts intercompany expense disallowance rules

80/20 Corporations

- ◆ Definition of “80/20 Corporation”: Any member with an average of its property, payroll, or sales factors within the United States of 20 percent or more
- ◆ **Apportionment Calculation for an 80/20 Corporation**
 - Apportionment calculation done on a stand alone basis
 - Three factor formula used without weighting of factors, unless a factor is missing or deemed inapplicable
 - U.S. factors include property, payroll and sales in any geographic area over which the U.S. has asserted jurisdiction or claimed exclusive rights with respect to the exploration of natural resources.

80/20 Corporations (cont.)

- ◆ In the case of a non-U.S. corporation, the income included in combined group income consists of the corporation's effectively connected income (ECI) and the corporation's U.S. source income that is not ECI.
 - Economic development bill, SB 2582 (signed Aug. 5, 2010). When a combined group computes its taxable income or loss on water's-edge basis, income of corporation organized outside of U.S. is not included in combined group's taxable income to extent the income is exempt from federal tax under a federal treaty
- ◆ If income is excluded, apportionment factors related to such income are similarly excluded.
- ◆ However, excluded income will be included for purposes of determining whether a foreign entity is considered to be a member of the water's edge-group

80/20 Corporations: Practical Implications

- ◆ Because the definition of “within the United States” includes U.S. territories and possessions, economic activity that is not subject to tax in the United States may be sufficient to bring a corporation within the water’s-edge group as an 80/20 corporation.
- ◆ U.S. source income that is not ECI may be brought into combined group income on account of the inclusion of an 80/20 corporation. As a result, intercompany expenses that previously were deducted for Massachusetts purposes are now eliminated.

Taxable Member with Economic Nexus

- ◆ Massachusetts DOR practice has been to assert economic nexus over intellectual property companies that derive royalties from the sale of tangible personal property in Massachusetts.
- ◆ Unlike corporations included as more than 20% income inclusion corporations, corporations included in the water's-edge group based on economic nexus are (presumably) included as taxable members.

Taxable Member with Economic Nexus

- ◆ For a non-U.S. corporation, income included in combined group income consists of effectively-connected income and U.S. source income that is not effectively-connected income
- ◆ The income and factors of such corporations are treated under the same rules that apply to 80/20 corporations
- ◆ Unlike an 80/20 corporation, if the economic nexus corporation is also an intellectual property corporation, then it will be subject to a Massachusetts tax on its apportioned share of its net worth



Michigan

The Michigan Standard for “Unitary Group”

“Unitary business group” means a group of United States persons, other than a foreign operating entity, one of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons... MCL 208.1117(6).

Unitary Group

- ◆ Under MCL § 208.1117(7), “United States person” means that term as defined in 26 U.S.C. § 7701(a)(30).
- ◆ Under MCL 208.1109(5), a “Foreign operating entity” means a United States person that satisfies each of the following:
 - Would otherwise be a part of a unitary business group that has at least 1 person included in the unitary business group that is taxable in this state.
 - Has substantial operations outside the United States, the District of Columbia, any territory or possession of the United States except for the commonwealth of Puerto Rico, or a political subdivision of any of the foregoing.
 - At least 80% of its income is active foreign business income as defined in section 861(c)(1)(B) of the IRC.

Michigan Taxation of Non-U.S. Persons

- ◆ **While not included in a unitary group, non-U.S. persons may still be subject to the MBT if conducting business in the state**
 - However, a foreign entity may not be subject to the MBT if the foreign person is domiciled in a subnational jurisdiction that does not impose an income tax on a similarly situated person domiciled in Michigan whose presence in the foreign country is the same as the foreign person's presence in the United States. Mich. Comp. Laws § 208.1207(1)(i)
- ◆ **In this regard, FAQ Mi20 provides that:**
 - Income excluded from federal taxable income pursuant to a treaty between the United States and a foreign country would also be excluded from the business income tax portion of the MBT.
 - However, non-U.S. persons are still liable for the modified gross receipts tax portion of the MBT
- ◆ **The Department has also indicated that it will extend the protections of P.L. 86-272 to non-U.S. business entities. See FAQ N9**

Other Issues

Expense Disallowance

- ◆ **For purposes of the BIT, a taxpayer must add back:**
 - Royalties, interest, or other expenses paid to a person related to the taxpayer by ownership or control for the *use of an intangible asset* if the person is not included in the taxpayer’s unitary business group

- ◆ **The Department has issued guidance defining “intangible asset” for purposes of the addback as:**
 - Those assets that cannot be seen, touched or physically measured and which are created through time and/or effort. Intangible assets may include but are not limited to patents, franchises, trademarks and goodwill. Intellectual property is an intangible asset and includes copyrights, trademarks, patents and trade secrets. See FAQ B54.



New York

Combined Reporting

- ◆ **Two elements required for combined reporting: unitary business and more than 50% stock ownership direct or indirect voting power**
- ◆ **Full unitary water's-edge method, with no "80/20 Rule"**
- ◆ **Combined group must include all U.S. corporations, alien corporations deemed U.S. "domestic" under the I.R.C. (contiguous, stapled and inverted corporations), and alien corporations with federal taxable income**
- ◆ **Seven-year affiliated group election could include all non-unitary GCT-classified affiliates (subject to the other elements, above)**

Specific Components Relevant to International Companies

- ◆ **Nexus jurisdiction would be based on so-called “economic nexus”, measured by a threshold of receipts from NY customers**
 - Traditionally, except for credit card banks, NY nexus has depended on physical presence
 - The Tax Department calculates that economic nexus neutralizes a tax-driven decision to locate in, or out, of NY
- ◆ **Alien corporations with a U.S. P.E. would conform their NY income base to IRC § 882 (ECI) or treaty income**
 - NY modifications would still apply, but no longer the infamous worldwide addback (as if a U.S. corporation)
- ◆ **Alien corporations without a U.S. P.E. would compute NY income per IRC § 882**

Wisconsin

Water's-Edge Rules

- ◆ **Wisconsin combined return is a water's-edge return with no worldwide election**
- ◆ **Inclusion of corporations under the water's-edge test**
 - Domestic corporations
 - Entity organized in the U.S. or non-U.S. entity electing to be included in federal consolidated return
 - Included in group if not an 80/20 corporation (including U.S. and foreign source items)
 - If 80/20 corporation (e.g., “consolidated foreign operating corporation”), include U.S. source and certain includable items as prescribed by Wisconsin law
 - Foreign corporations
 - Corporation organized outside of the U.S.
 - Included in group if not an 80/20 corporation
 - Excluded from group if an 80/20 company

Water's-Edge Rules

- ◆ **80/20 corporation defined as having 80% or more of worldwide gross income during taxable year is “active foreign business income” as defined in IRC section 861(c)(1)(B)**
- ◆ **Foreign group member not qualifying as 80/20 corporation only includes U.S. source income (as defined in IRC Sections 861 to 865) in the combined report**
 - Income “effectively connected” with conducting trade or business within U.S. considered U.S. source
 - Only factors related to such U.S. Source income included
- ◆ **Domestic corporation qualifying as 80/20 corporation includes**
 - U.S. sourced interest income or income from intangible property
 - U.S. sourced dividends from non-qualified (“captive”) REIT
 - Gains or losses from sale or lease of real or personal property located in the U.S.

Related Party Expense Addback

- ◆ Generally, addback required for interest expenses, rent expenses, intangible expenses and management fees paid to a related party
- ◆ Addbacks not required for transactions between combined group members if both payer's expense and payee's corresponding income included in the combined unitary income
- ◆ Addback modifications required (subject to certain exceptions) where related income is excluded from the combined items under the water's edge rules
- ◆ Exception to addback rules
 - Business purpose, arm's-length and meaningful change in taxpayer's economic position outside of tax effects
 - Related entity subject to tax on or measured by net income in another jurisdiction (jurisdiction's tax rate at least 80% of taxpayer's aggregate tax rate)
 - Related party expense indirectly paid to a third party



Selected Topics in Combined Reporting

Selected Topics in Combined Reporting

◆ Foreign Entity Inclusion In Water's-Edge Returns

– Controlled Foreign Corporations

■ Subpart F entities

– California partial inclusion rule

– Montana state adjustments

■ 80% DRD limited to combined or consolidated filers

Selected Topics in Combined Reporting

◆ Foreign Entity Inclusion In Water's-Edge Returns

– Treaty Application

■ California

- No treaty exemption
- If less than 20% U.S. activity, only ECI and factors included

■ General Conformity Approach

- Conforms to federal determination of taxable income base

Selected Topics in Combined Reporting

◆ “Tax Haven” States

- Requires the income and factors of foreign corporations organized or doing business in certain “tax haven” countries to be included in the water’s edge group
- Included in MTC model combined reporting statute
- Adopted in Montana and West Virginia

Selected Topics in Combined Reporting

◆ “Tax Haven” States

- Arguments against inclusion of tax haven businesses
 - Goes against intent of water’s edge election
 - Violates Foreign Commerce Clause
 - Impacts foreign relations, which is best left to the federal government
- Lack of clarity as to which countries are considered “tax havens”
 - Some statutes give broad authority to the Tax Commissioner to make this determination
 - CA references GAO 09-157 as modified by U.S. Secretary of the Treasury Order after 1/1/2011

Selected Topics in Combined Reporting (Cont.)

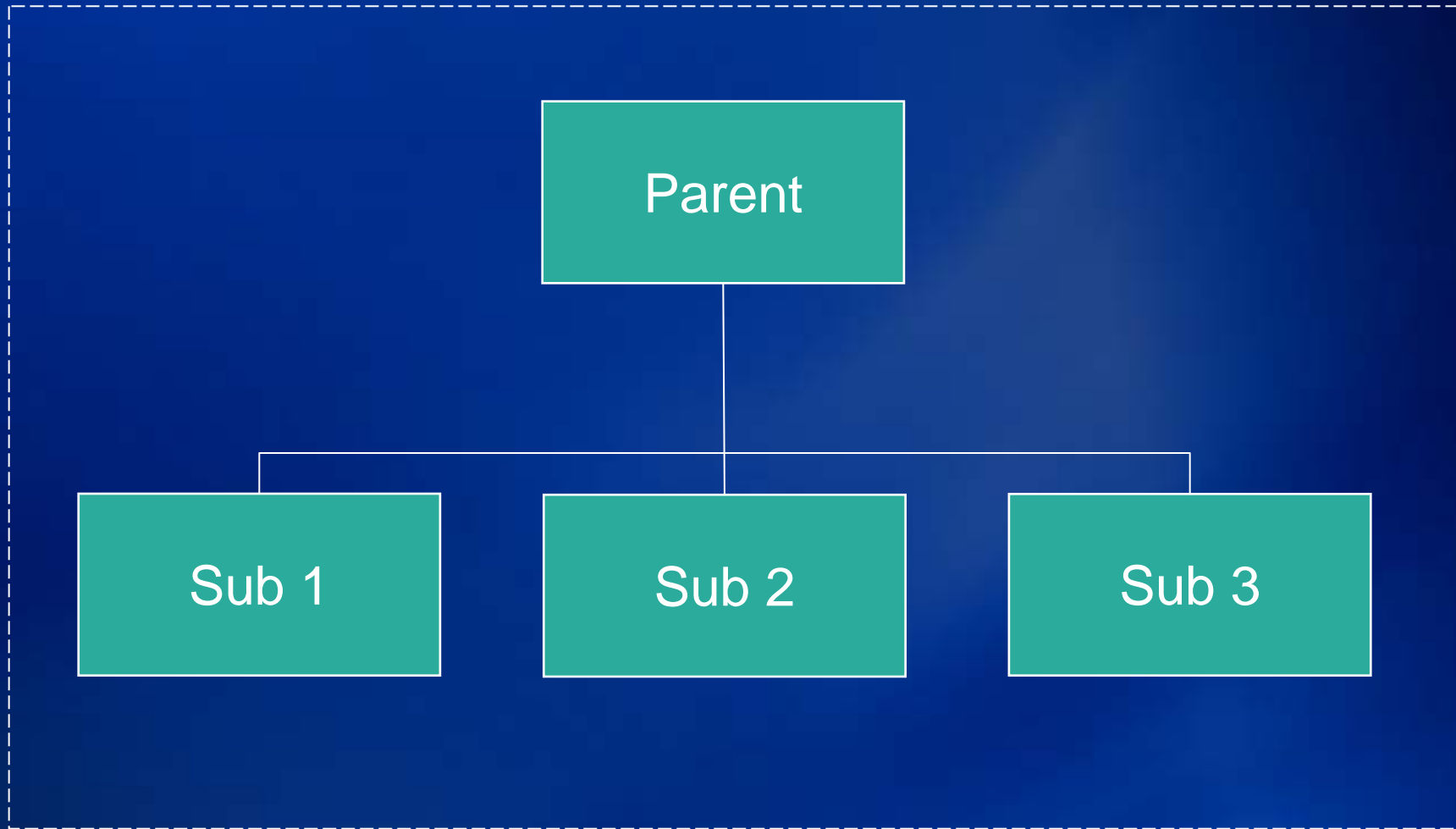
◆ Administration's International Proposals

- Defer deduction of interest related to deferred income
 - Substantially pared down from prior proposal
- Tighten Sec. 482 for intangibles transferred to foreign entities
 - Tax “excess returns” on a current basis
 - Clarify what constitutes intangibles and treatment of certain transactions
- Increased reporting of foreign accounts and transactions

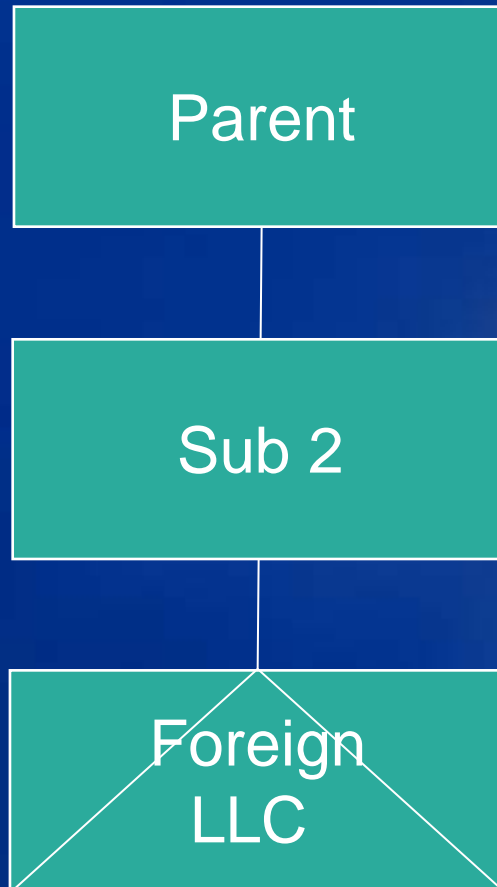


Inclusion of Foreign Entities in Unitary Group

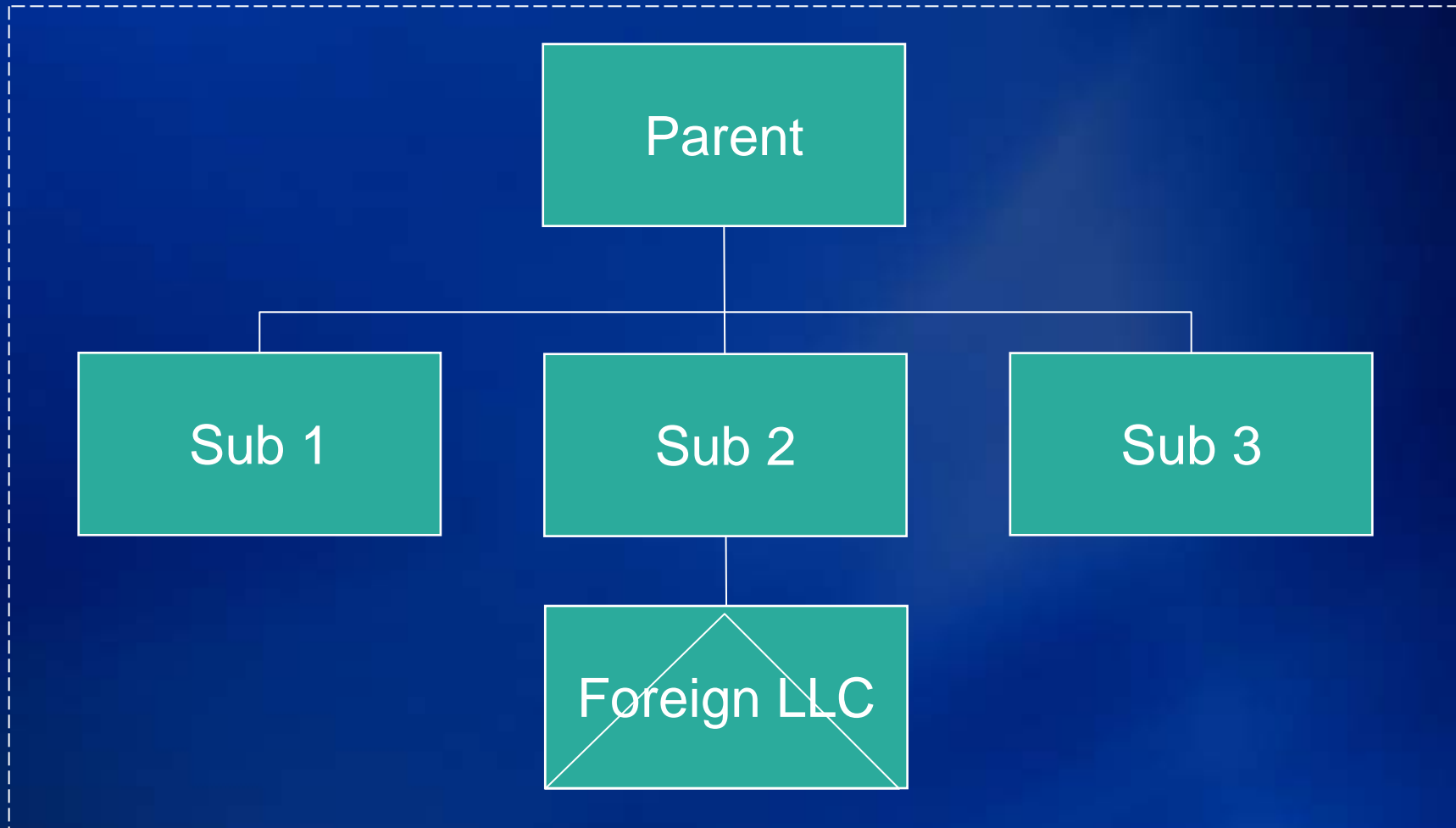
Example – Unitary Group



Example – Conversion of Foreign Entity



Example – Revised Unitary Group



Example – Foreign Jurisdiction Treatment

- **Foreign LLC should be taxed as a separate legal entity in various foreign jurisdictions**
- **The conversion of the foreign corporation to an LLC may be tax free in the foreign jurisdiction**
- **Foreign LLC may be taxed as a corporation in the foreign jurisdiction**
- **Sub 2 should not be taxed in the foreign jurisdiction unless it derives income in that jurisdiction**

Proposed Structure – Federal Treatment

- For U.S. federal income tax purposes (and most states), Foreign LLC should be disregarded and treated as a division of Sub 2
- Income from Foreign LLC will be subject to federal income taxes as a “division” of Sub 2
- If the foreign jurisdiction tax rate is higher than the federal tax rate, the foreign tax credit should offset any potential federal income tax
- The foreign tax credit will need to be reviewed to ensure no additional overall federal or foreign income taxes

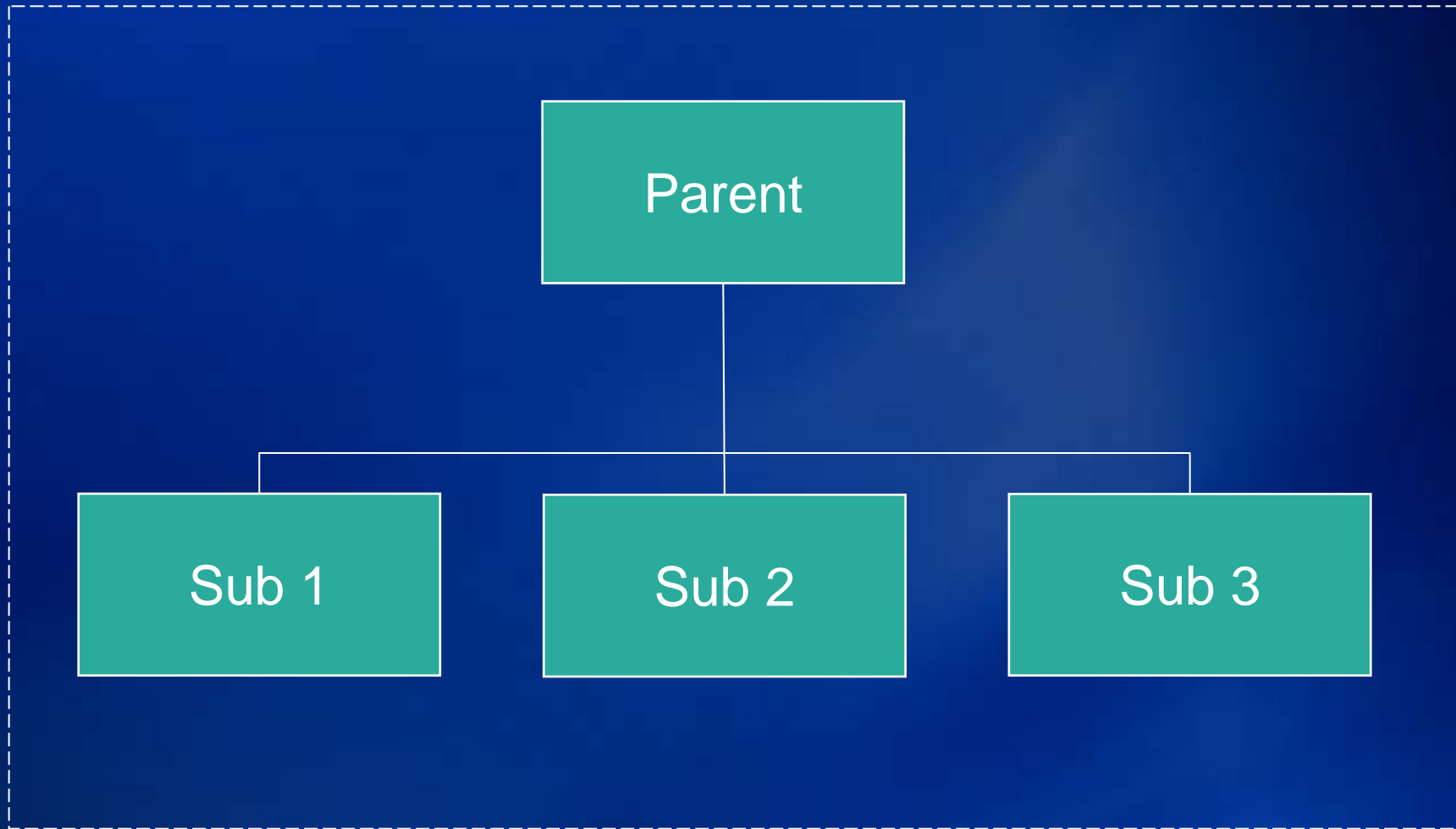
Proposed Structure – State Treatment

- **Some states exclude 80/20 entities if payroll/property outside of the U.S. is greater than 80% (IL) or if the foreign source income is greater than 80% (WI, MI)**
- **Thus, if the combined payroll/property and/or sales of the combined entity are more than 20% in the U.S., the combined entity should be part of the unitary group**
- **The impact in other unitary states/franchise taxes will need to be determined**

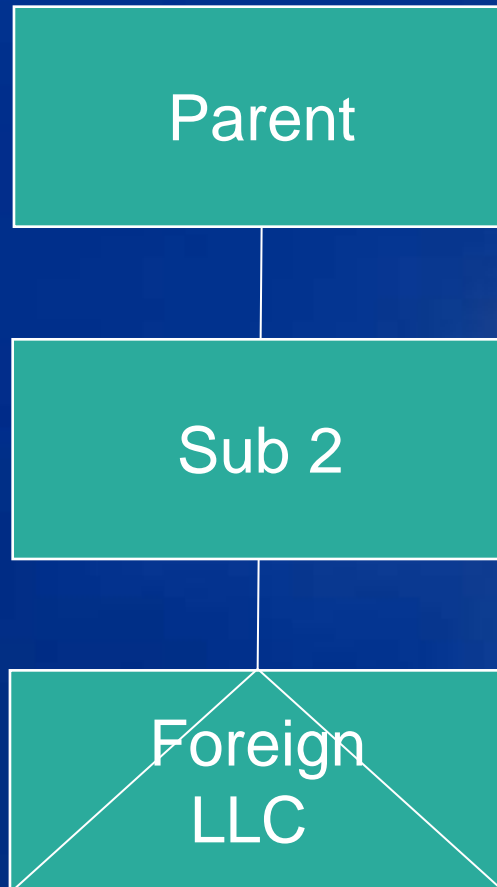


Exclusion of Foreign Entities from the Unitary Group

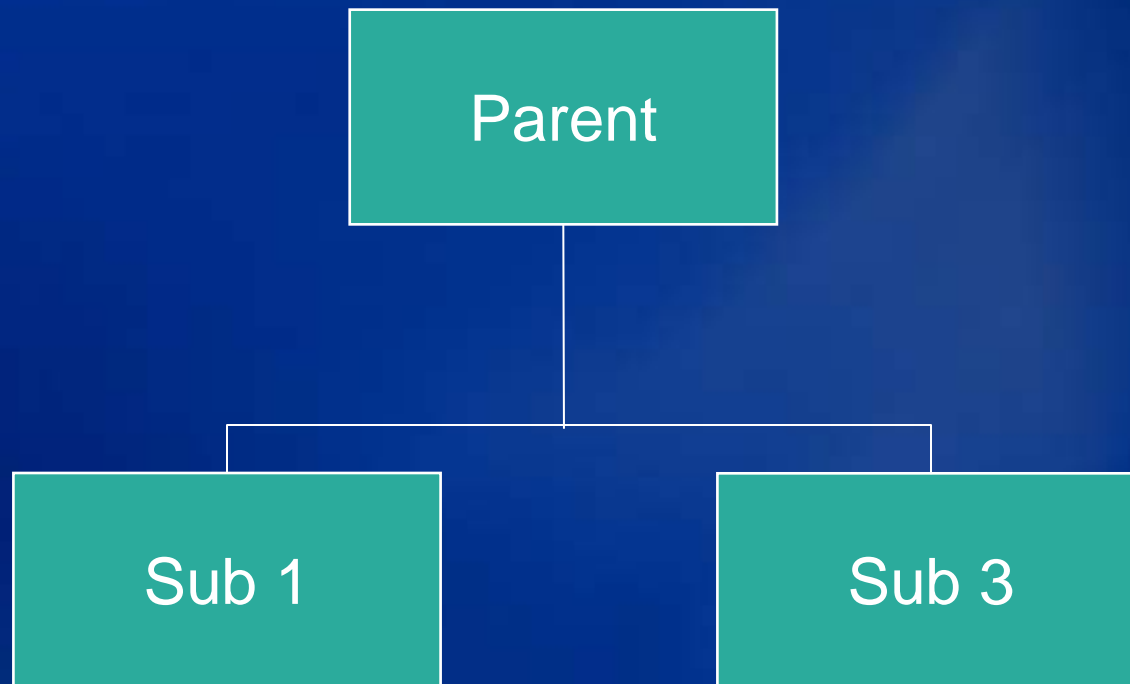
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Proposed Structure – State Treatment

- States like IL exclude 80/20 entities if payroll/property outside of the U.S. is greater than 80% (similar rules in MN and TX)
- Thus, converting a foreign entity into a SMLLC under a U.S. entity may convert the U.S. entity to an 80/20 company and be excluded from the unitary group
- The impact in other unitary states/franchise taxes will need to be determined

Potential State Challenges

- **Zebra Technologies Corp. v. Topinka**, 799 N.E.2d 725 (Ill. App. Ct. 2003) – payroll of activities of U.S. parent/affiliates conducted on foreign entity's behalf and thus, not an 80/20 entity