Montana Department of Revenue

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Director

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Memorandum

To: Director Kadas

From: Marla Larson, Tax Policy and Research *MCL*

Date: May 24, 2016

Subject: Discussion of federal vs. state taxes and worldwide combined filing and water's edge

U.S. tax law requires U.S. based companies to report their domestic and certain foreign income (after adjustments and deductions, etc.), then calculate their tax liability based upon that income. The corporation can take a credit for foreign income taxes, or income-like taxes such as an excess profits tax, paid on the non-U.S. income. The intent of the credit is to avoid double taxation of foreign income of U.S. companies.[i]

This process worked reasonably well when the countries these companies did business in had tax rates similar to that of the U.S. Example 1 to the left shows the result when effective foreign and U.S. tax rates are the same (simplified here to the top U.S. statutory rate of 35%). The credit for foreign income taxes paid of $14 million reduces the corporation's U.S. tax liability to $21 million which is 35% of $60 million.

Example 1 - U.S. and Foreign Effective Tax Rates are the Same.

U.S. multi-national corporation	
Net taxable income from domestic business activities	$60,000,000
Net taxable income from foreign business activities	40,000,000
Total Net Taxable Income	$100,000,000
U.S. Corporate Income Tax Rate	35%
U.S. Tax Liability before credit	$35,000,000
minus credit for foreign income taxes paid	14,000,000
U.S. Tax Liability after credit	$21,000,000

Example 2 - Foreign Effective Tax Rates are Half U.S. Tax Rate.

U.S. multi-national corporation	
Net Income from domestic business activities	$60,000,000
Net Income from foreign business activities	40,000,000
Total Net Income	$100,000,000
U.S. Corporate Income Tax Rate	35%
U.S. Tax Liability before credit	$35,000,000
minus credit for foreign income taxes paid	7,000,000
U.S. Tax Liability after credit	$28,000,000

Over the last decade and more, many countries have lowered their tax rates or offered other tax breaks, in part to attract more development by U.S. based or other corporations. Consequently the value of the federal credit for foreign income taxes has diminished as many multi-national corporations no longer pay as much foreign tax on their reported foreign income, (see what happens in Example 2 where the effective tax rate for the U.S. is 35% and the effective tax rate on foreign income is 17.5%).

However the situation shown in Example 2 rarely happens in reality. This is because there is a "loophole"[ii] in federal law allowing U.S. based corporations to postpone U.S. taxes on most foreign income by postponing "repatriating" the income (by paying the income as a dividend to the parent). There is effectively no time limit on when a U.S. based corporation must repatriate much of its foreign earned income. But there is a cost because non-repatriated income is not available to pay U.S. shareholder dividends, management bonuses or invest in U.S. operations, although some corporations have found creative ways around the issue.

In 2004 Congress approved a repatriation holiday during which corporations could bring back non-repatriated foreign earned income and pay a relatively low tax rate (5.25%) on those earnings.[iii] Ever since many multi-national corporations have been waiting, and sometimes lobbying for, a repeat of the holiday or for more significant federal tax reform. Meanwhile the foreign earnings "trapped", or non-repatriated, of the corporations making up the S&P 500 has grown to an estimated $2.2 trillion.[iv] This revenue has grown to be so substantial for some companies that it has generated an increased number of high-profile tax inversions. The following information on tax inversions is from the Tax Foundation website:

> **What is an inversion?**
>
> In its simplest form, an inversion is simply the process by which a corporate entity, established in another country, buys an established American company. The transaction takes place when a foreign corporation purchases either the shares or assets of a domestic corporation or when a U.S. corporation purchases the share or assets of a foreign corporation. Some inversions involve the purchase of both the shares of ownership and the corporate assets. The shareholders of the domestic company typically become shareholders of the new foreign parent company. In essence, the legal location of the company changes through a corporate inversion from the United States to another country. An inversion typically does not change the operational structure or functional location of a company.
>
> **How does an inversion benefit the U.S. corporation?**
>
> The change in legal residence from the United States to another country allows the company to take advantage of the more favorable tax treatment of the new home country.

> The most obvious benefit is that most countries do not have a worldwide corporate income tax system. The United States taxes income earned by U.S. corporations no matter where they earn that income, domestically or abroad.[v]

State taxation of corporate income takes a different approach from federal corporate income taxation when it comes to calculating taxes. At the state level if 100% of a corporation's business is done in the state, then 100% of the net income is taxable by the state. But if only 10% of a corporation's total business is done in the state, then this fact needs to be recognized in the calculation of state taxes.

Example 3 - State tax calculation

U.S. multi-national corporation - worldwide combined	
Net taxable income from domestic business activities	$60,000,000
Net taxable income from foreign business activities	40,000,000
Total Net Taxable Income (FTI)	$100,000,000
Montana Adjustments to FTI	
Additions	$10,000,000
Subtractions	-$3,000,000
Adjusted Federal Taxable Income	$107,000,000
Calculate the apportionment factor:	
Payroll Factor	10%
Sales Factor	5%
Property Factor	15%
Sum of all factors	30%
Average or apportionment factor	10%
Montana Taxable Income before NOLs	$10,700,000
Minus Net operating losses	-$5,000,000
Montana Taxable Income	$5,700,000
Montana Corporate Income Tax Rate	6.75%
Montana Tax Liability before credits	$384,750
minus any Montana Credits	-500
equals Montana Tax Liability	$384,250

But now the practical questions arise. How do we figure out what share of a multi-jurisdictional corporation's business is done in state? And is it possible to do this simply with data the taxpayer is likely to already have?

The methodology used is the apportionment factor. The factors adopted by Montana and a number of other states are payroll, sales and property. The apportionment factor is the equally weighted average of the ratios of Montana payroll to total payroll, Montana sales to total sales, and Montana property to total property.

In example 3 to the left, the starting point is the corporation's taxable income reported for federal purposes (FTI). Because it has already been calculated for federal taxes, it is more convenient and efficient, for both the taxpayer and the tax administrator, to start with FTI in calculating state taxable income. Montana requires certain additions and subtractions to FTI in order to arrive at adjusted federal taxable income.[vi]

Adjusted federal taxable income is then apportioned to Montana based upon the three factor apportionment percentage (in example 3 it is 10%). Once income apportioned to Montana is calculated, any net operating losses carried over from other years are subtracted, resulting in Montana taxable income. Montana taxable income times the tax rate yields Montana tax liability. Then if the taxpayer is entitled to any tax credits, those are subtracted, reducing tax liability.

Because the calculation at the state level <u>starts</u> with federal taxable income, there can be confusion about whether the state is over-reaching when it calculates state taxes. But as can be seen in Example 3, that's certainly not the case, since the state tax is calculated based upon the much smaller share of taxable income justified by the apportionment factors. And the elements used in the apportionment factors - payroll, sales and property - must match up with the income being apportioned.

If a multi-national corporation choses to file as a water's edge corporation, the income/expenses of certain of its non-U.S. entities are excluded (mostly) from the tax calculation. The apportionment factors need to be adjusted to align with the income (15-31-322 – 323, MCA). The state statutory tax rate also goes up to 7% from 6.75%.

Example 4 illustrates what changes in the apportionment factor calculation when a corporation moves from worldwide combined to water's edge. In this hypothetical example, the apportionment factor goes from about 10% to about 20% because while Montana sales, property and payroll remain the same, the respective totals change because some of the corporation's units are no longer included.

Example 4 - Comparison of Apportionment Factors for Multi-national Corporation filing as Worldwide Combined and as Water's Edge

Worldwide Combined

Factor	Montana	Total		Apportionment Factor
Sales	$100,000	$10,000,000		0.0100
Property	$1,500,000	$6,000,000		0.2500
Payroll	$500,000	$10,000,000		0.0500
Sum				0.3100
Average				0.1033
			or	10.3%

Water's Edge

Factor	Montana	Total		Apportionment Factor
Sales	$100,000	$5,000,000		0.0200
Property	$1,500,000	$3,000,000		0.5000
Payroll	$500,000	$5,000,000		0.1000
Sum				0.6200
Average				0.2067
			or	20.7%

So why would a company choose to file as a water's edge corporation? Because the total income the apportionment factor is multiplied by decreases too when the foreign earned income is excluded. The larger the percentage of total income is foreign earned, the more Montana taxable income is reduced.

But another contemporary business practice, profit shifting, used by some multi-nationals, can make the water's edge election much more attractive. A simple example of profit shifting, although there are many, is for a corporation to transfer its patents, or other intellectual property rights, out of its U.S. units into an overseas unit it has created in a country with favorable laws. The U.S. units of the corporation pay fees to the patent-holding unit for use of the technology which means that the U.S. units can deduct those fees as expenses against income and reduce their taxable income. If the corporation is a water's edge filer the patent-holding unit's income may not be included in state taxable income. And depending upon the laws of the country where the patent-holding unit is incorporated, the unit's income from fees may be taxed lightly or not at all.[vii]

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[i] The examples and discussion here only pertain to U.S. based corporations and do not include corporations with a foreign parent. For more information on the issues see Gravelle, J.G. (2012). *Moving to a Territorial Tax: Options and Challenges*. Washington, DC: Congressional Research Service https://www.fas.org/sgp/crs/misc/R42624.pdf

[ii] Loophole is in quotes because the provision did not start out as a loophole, but reflects the principle that revenue should be taxed only when it has been realized as net income or profit by the taxpayer. But it has

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evolved into a way for certain corporations to postpone U.S. taxes, often indefinitely, especially when coupled with other strategies such as earnings stripping or tax inversions. (http://knowledge.wharton.upenn.edu/article/why-new-u-s-rules-wont-completely-halt-tax-inversions).

[iii] http://www.cbpp.org/research/repatriation-tax-holiday-would-increase-deficits-and-push-investment-overseas

[iv] http://www.wsj.com/articles/sheltering-foreign-profits-from-u-s-taxes-is-no-big-feat-1461627831.

[v] http://taxfoundation.org/blog/everything-you-need-know-about-corporate-inversions

[vi] Additions include federal tax exempt interest; state, local, foreign and franchise taxes based on income; income/loss of a foreign parent and foreign subsidiaries for worldwide combined filers; premiums used to calculate the Insure Montana credit; income/loss of affiliates incorporated in tax havens for water's edge filers only; and others. Reductions include certain transfers of income between corporate units; nonbusiness income; the Montana recycling deduction; income/losses from 80/20 companies for water's edge filers only; and others.

[vii] The examples and the discussion are simplified in order to illustrate certain general points and do not address many of the complexities of tax accounting and federal and state corporate tax law.