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External Multistate Tax Alert
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Proposed Section 965 and GILTI Regulations May Result in Federal/State Income Tax Differences

Overview

On August 1, 2018, Treasury and the Internal Revenue Service (IRS) issued proposed regulations regarding computations related to the deemed repatriation of E&P of certain entities pursuant to Section 965 (Proposed Section 965 Regs). On September 13, 2018, Treasury and the IRS also released proposed regulations regarding the computation of global intangible low taxed income (Proposed GILTI Regs).

As a number of states do not fully conform to the federal consolidated return regulations, including both separate company filing states and certain unitary states, provisions of both proposed regulations may result in federal/state income tax differences as is discussed below.

Proposed Section 965 Regulations

The Proposed Section 965 Regs provide guidance in a number of areas related to Section 965 deemed repatriation, notably how the deemed repatriation is recognized in the context of a consolidated group, which can be different from instances where entities are affiliated but no federal consolidated group election has been made.

Affiliated Groups. Pursuant to the statute, a corporation that would have an inclusion under Section 965(a) with respect to its foreign subsidiaries generally can offset that amount by its share of any net E&P deficit of another corporation with which it is "affiliated" under the definition in Section 1504 of the Internal Revenue Code. This net E&P deficit would otherwise go unused as a shareholder cannot recognize any amount less than zero for purposes of Section 965(a). If there are multiple affiliates with a net E&P deficit, the affiliated group's aggregate net E&P deficit is allocated to affiliates that would have an inclusion under Section 965(a) based on the relative amounts of such inclusion to the group's total inclusion.

Because Section 965 only requires that entities meet the definition of "affiliated" under Section 1504 and does not require the filing of a consolidated return for the above rules to apply, it generally would apply in states that do not adopt the federal consolidated return rules.

Consolidated Groups. Proposed Treasury Regulation section 1.965-8 makes clear that members of a consolidated group are not to be treated as a single corporation for all purposes of Section 965(a), including the amount of the inclusion under Section 965(a). However, it does provide different netting rules to those described above for affiliated groups where corporations file as part of the same consolidated group. The E&P netting rules described above are implemented *at the shareholder level*. In other words, each US shareholder first nets the E&P inclusion amounts and deficits of its own foreign subsidiaries before allocating the group's unused E&P deficits at the shareholder level to other members. In a consolidated group, however, that E&P netting is effectively done *at the foreign subsidiary level* across all subsidiaries owned by the consolidated group members that are also US shareholders, with the aggregate amount of E&P deficits of all such foreign subsidiaries allocated proportionally based on each foreign subsidiary's relative section 965(a) earnings amount. The net E&P amount at the foreign subsidiary level then results in a Section 965(a) inclusion amount at the member level. Accordingly, the amount included by a specific member under section 965(a) may differ depending on whether a consolidated or affiliated group approach is applied.

The federal consolidated group netting approach would generally not apply in states that require separate filing or require members of a combined group to calculate income without application of the federal consolidated return rules. While a large number of states that conform to the current version of the IRC permit a 100% dividends received deduction for a deemed dividend, the impact of this netting variance would need to be considered in states such as Louisiana and New

Jersey, which conform to the current version of the IRC yet provide for a dividends received deduction that is less than 100%.[1]

Proposed GILTI Regulations

The Proposed GILTI Regs introduce a similar concept for tested income and tested loss amounts *that is only applicable to members of a consolidated group*. Specifically, proposed Treasury Regulation section 1.1502-51 would treat tested losses of a CFC as a group asset in the first instance that is allocated to all members with positive tested income based on each member's share of total positive tested income of the consolidated group.[2] As illustrated in the example below, there is no direct netting by a US shareholder that owns CFCs with both tested income and tested loss.

> Parent Corporation owns 100% of subsidiary 1 (S1) and subsidiary 2 (S2). S1 owns 100% of CFC1. S2 owns 100% of CFC2 and CFC3. CFC1 has $100 of tested income. CFC2 has $100 of tested income. CFC3 has $100 of tested loss. Under the proposed regulation, S2 does not net the tested loss of CFC3 against the tested income of CFC2 resulting in $0 net tested income for S2. Rather, the regulations require that the $100 tested loss of CFC3 be allocated to S1 and S2 based on a ratio of tested income of each member over consolidated tested income. Accordingly, S1 and S2 are each allocated $50 of CFC3's $100 tested loss, resulting in S1 and S2 each having net tested income of $50.

Outside of a consolidated group context, Section 951A, unlike Section 965 does not permit any offsetting between affiliated entities. Therefore, in states that do not adopt the federal consolidated return regulations, a US shareholder would need to determine its net tested income or loss based on its ownership of any CFC (directly or indirectly) within the meaning of section 958(a) and would not be able to benefit from any affiliate's tested loss. Accordingly, in the above example, S1 would have $100 of net tested income and S2 would have $0 of net tested income. It would also follow that absent the application of the consolidated allocation principles in the proposed regulation, it is possible for individual members of the consolidated return group to have tested income for state tax purposes notwithstanding the consolidated group is in a net tested loss position. Analysis may be worthwhile relative to limiting the presence of a company's US shareholders to jurisdictions that conform to the consolidated return regulations, or to jurisdictions that otherwise exempt or permit a deduction for any GILTI inclusion amounts.

The proposed regulations also contain amendments to the stock basis adjustment rules of Treasury Regulation section 1.1502-32. Specifically, the proposed amendments would require basis adjustments (reductions) to the stock of a member owning a tested loss CFC to the extent the tested loss of such tested loss CFC is used to offset tested income of other group members. The existing investment adjustment provisions would require an increase to the basis of member stock by that member's GILTI inclusion amount. The proposed regulations further provide that the amount of the member's offset tested income may increase its basis, subject to deferral rules including upon a taxable disposition of such member at a later date or the recognition of a used tested loss amount in a future U.S. shareholder inclusion year. The proposed regulations also contain basis adjustment rules for the underlying CFC stock owned by members, which provide for a reduction in the basis of CFC stock for net used tested loss amounts associated with such CFC, subject to certain deferral rules including upon a taxable disposition of such CFC, with the consolidated rules differing from the application on a separate entity basis. This highlights another instance where tracking a separate state basis is necessary in order to determine the proper calculation of the state tax gain/loss amount upon sale of the shares of effected members and CFCs in state that do not conform to the 2017 Tax Act (or do conform to the 2017 Tax Act yet do not adopt the federal consolidated return regulations.)

As of the date of this tax alert, more than fifteen states require inclusion of a taxpayer's GILTI income in the taxable income starting point. In some of these states, the 50% deduction provided by Section 250 may not be available. Given the nature of GILTI (as compared to Section 965(a) deemed repatriation income) a dividend received deduction may not be available in many of these states to offset the GILTI income. Thus, nonconformity to the consolidated return rules may be more impactful for state tax purposes with regard to GILTI than in the Section 965(a) context discussed above relative to the E&P netting rules.

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[1] New Jersey recently created a Form CBT-DIV 2017 to supplement the 2017 Form CBT 100 or BFC-1 to account for the impact of IRC Section 965 upon the New Jersey Corporate Business Tax (CBT). The Form CBT-DIV (which is required to be filed by January 31, 2019) for TY2017 calendar year taxpayers, is available here.

[2] This same allocation methodology also applies to consolidated QBAI and specified interest expense.

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