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SHOP TALK

Oregon's Treatment of the Federal Deemed Repatriation

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The December 2017 federal tax reform law, commonly referred to as the Tax Cuts and Jobs Act or TCJA, overhauled many aspects of U.S. tax law. One of the more significant changes for U.S. corporations was to shift U.S. taxation from a worldwide system to a more territorial system. The TCJA did not create a pure territorial system because it did not change the "from whatever source derived" prong of the definition of gross income provided by IRC Section 61(a). However, the TCJA added new IRC Section 245A, which generally provides a 100% dividends received deduction ("DRD") for dividends received by a U.S. corporation from 10% or greater owned non-U.S. corporations.

To prevent permanent exclusion of deferred income earned by non-U.S. corporations, the TCJA created a transition tax imposed pursuant to IRC Section 965 which, as described below, effects a deemed repatriation from certain non-U.S. corporations. Congress did not limit this transition tax to corporations, even though only corporations may claim the IRC Section 245A DRD. State reaction to this deemed repatriation has varied. This article discusses the Oregon tax treatment.

Summary of the IRC Section 965 deemed repatriation

A detailed discussion of IRC Section 965 is beyond the scope of this article. As a general matter, IRC Section 965 applies to a "deferred foreign income corporation," which generally is defined as a controlled foreign corporation[1] or any non-U.S. corporation in which a U.S. corporation owns 10% or more of the vote or value.[2] The Subpart F income of a deferred foreign income corporation includes the IRC Section 965 deemed repatriation amount.[3] Each U.S. person that owns 10% or more of the vote or value of the deferred foreign income corporation includes in income its pro rata share of the corporation's Subpart F income (which includes the IRC Section 965 deemed repatriation).[4]

To calculate the IRC Section 965 deemed repatriation amount, one starts with the accumulated post-1986 deferred foreign income of the deferred foreign income corporation as of November 2, 2017, or December 31, 2017, whichever is greater.[5] Detailed rules apply to determine the applicable deferred foreign income amount. IRC Section 965(c) then allows taxpayers a deduction, essentially a DRD, so that the tax on the IRC Section 965 deemed repatriation, applying the 35% maximum corporate tax rate in effect before the TCJA, is (a) 15.5% for cash and cash equivalents included in the deemed repatriation, and (b) 8% for the other portions of the deemed repatriation.

> **Example:** FC, a non-U.S. corporation, is wholly owned by DC, a U.S. corporation, and has deferred foreign income of $10 million, consisting of $1 million of cash and $9 million of other property. The 15.5% tax on the $1 million of cash is $155,000, which is 35% of $442,857, requiring an IRC Section 965(c) DRD for the cash portion of $557,143. The 8% tax on the $9 million of other property is $720,000, which is 35% of $2,057,143, requiring an IRC Section 965(c) DRD for the other property portion of $6,942,857. The total IRC Section 965(c) DRD is **$7.5million** and the net deemed repatriation included in DC's federal taxable income is **$2.5 million.**

Oregon corporation excise tax treatment of the deemed repatriation

The starting point for determining a corporation's Oregon taxable income is its federal taxable income.[6] This starting point automatically takes into account federal tax law changes like the TCJA.[7] Adjustments required by Oregon law are then made to this starting point amount to determine apportionable income. These adjustments include the Or. Rev. Stat. §317.267(1) addback of certain federal DRDs and the Or. Rev. Stat. §317.267(2) application of an 80% Oregon DRD (70% if the recipient owns less than 20% of the corporation) for dividends and deemed dividends. The corporation then apportions its apportionable income to Oregon based on single factor sales. The deemed repatriation affects the calculation of apportionable income and the Oregon sales factor.

Impact of the deemed repatriation on apportionable income. Rather than provide a broad addback of any federal DRD, Or. Rev. Stat. §317.267(1) specifies the addback by IRC section. Because there was no IRC Section 965(c) DRD before the TCJA, Or. Rev. Stat. §317.267(1) did not require an addback of the IRC Section 965(c) DRD when Congress enacted the TCJA. Absent a change in Oregon law, this meant that, in calculating Oregon taxable income, (1) there was no addback of the IRC Section 965(c) DRD, but (2) a corporate taxpayer could get an 80% Oregon DRD on the gross deemed repatriation amount.

In the example above, the deemed repatriation would have resulted in a **decrease** in Oregon taxable income of $5.5 million ($2.5 million included in starting point less $8 million Oregon DRD (80% of $10 million gross deemed repatriation)). In other words, a federal revenue raiser would have reduced Oregon taxable income. During the 2018 legislative session, the Oregon Legislature amended Or. Rev. Stat. §317.267(1) to require an addback of the IRC Section 965(c) DRD.[8] Accordingly, 20% of the deemed repatriation (70% if the corporation owns less than 20% of the foreign corporation) is included in apportionable income.

Impact of the deemed repatriation on the Oregon sales factor. The Oregon sales factor impact of the deemed repatriation depends, in part, on whether the deemed repatriation is included in income for tax years beginning before January 1, 2018.[9] For tax years beginning before January 1, 2018, Oregon apportioned receipts from sales other than sales of tangible personal property based on costs of performance.[10] For tax years beginning on or after January 1, 2018, Oregon applies a market-based sourcing method to such receipts.[11] On November 9, 2018, the Oregon Department of Revenue ("Department") issued Oregon Revenue Bulletin 2018-01, which discusses the sales factor impact of the deemed repatriation for both periods.

For a 2017 deemed repatriation, the Department, citing *former* Or. Rev. Stat. §314.665(6)(a), stated that the deemed repatriation is excluded from the Oregon sales factor "unless the repatriation gross receipts are derived from the taxpayer's primary business activity." For a 2018 deemed repatriation, the Department, citing Or. Rev. Stat. §314.610(7), stated that the deemed repatriation is excluded from the Oregon sales factor "unless the receipts are received from transactions and activities in the regular course of the taxpayer's trade or business."

The bulletin generally indicates that the deemed repatriation always is excluded from the sales factor. After all, the only example excludes the deemed repatriation from the Oregon sales factor for both periods:

> **Example:** Corporation XYZ repatriates the following amounts on account of its 100% ownership interest in the foreign corporation SUB XYZ: $10 million in 2017 and $10 million in 2018. Corporation XYZ is engaged in the primary business activity of shipbuilding. SUB XYZ, a part of CORP XYZ's unitary business, is engaged in financial services. Corporation XYZ would exclude the 2017 repatriation from its sales factor because Corporation XYZ's ownership interest in SUB XYZ isn't derived from Corporation XYZ's primary business activity of shipbuilding. Furthermore, Corporation XYZ would exclude the 2018 repatriation from its sales factor because the one-time mandatory repatriation Corporation XYZ receives isn't received from transactions and activities in the regular course of Corporation XYZ's trade or business and in any event is excluded from the sales factor under Or. Rev. Stat. §314.666.[12]

However, for a 2017 deemed repatriation, if the ownership of the interests in the non-U.S. corporation is derived from the taxpayer's primary business, the deemed repatriation amount may be includible in the Oregon sales factor. The Department's example quoted above does not give background for SUB XYZ, but what if CORP XYZ formed or acquired SUB XYZ for financial services related to its shipbuilding operations? For 2018 deemed repatriations, the Department describes how the deemed repatriation is never included in the Oregon sales factor "because the one-time mandatory repatriation * * * isn't received from transactions and activities in the regular course of" the recipient's trade or business. What if the non-U.S. corporation regularly pays dividends and/or earns Subpart F income? Despite the one-time nature of the deemed repatriation, federal tax law treats the deemed repatriation as Subpart F income, which Oregon tax law treats as a deemed dividend. It is unclear why the deemed repatriation would be treated differently than other Subpart F income or dividends.

Oregon personal income tax treatment of the deemed repatriation

Oregon taxes Oregon residents on worldwide income, with Oregon taxable income based on the resident's federal taxable income, to which the modifications required by Oregon law then apply.[13] Accordingly, the deemed repatriation net of the IRC Section 965(c) DRD is included in Oregon taxable income. A question arises, however, as to whether Oregon law requires an addback of the IRC Section 965(c) DRD.

No provision in Oregon personal income tax law specifically requires an addback of the IRC Section 965(c) DRD.[14] Nonetheless, the Department announced in a March 19, 2018 Revenews[15] that individuals must add back the IRC Section 965(c) DRD. The Department apparently based this on Or. Rev. Stat. §316.737, which provides:

> If a taxpayer has taken a deduction to arrive at federal taxable income for the purpose of having that income taxed in a manner different from the taxation of federal taxable income, **the amount which was deducted and specially taxed** shall be added to federal taxable income in the computation of state taxable income. However, if any portion of the amount added was treated as capital gain in arriving at federal taxable income, that portion shall be treated as capital gain in the computation of state taxable income. (Emphasis added)

Because the Or. Rev. Stat. §316.737 addback applies to an amount that is deducted **and** specially taxed, it does not appear that it would apply to the IRC Section 965(c) DRD—the IRC Section 965(c) is not specially taxed.[16] Accordingly, individuals who added back the IRC Section 965(c) DRD generally should consider filing an amended return claiming a refund.

Conclusion

The IRC Section 965 deemed repatriation is complicated at the federal level, and possibly even more complicated at the state level. In Oregon, the legislature fixed the potential unintended consequence of the deemed repatriation reducing a corporation's apportionable income. The Department has provided guidance concerning the sales factor impact of the deemed repatriation, but that guidance raises questions that the courts may need to resolve. The Department also provided guidance about the impact on individuals, but that guidance may be incorrect.

[1] Defined by IRC Section 951(b) as a non-U.S. corporation in which U.S. persons that own 10% or more of the vote or value of the non-U.S. corporation collectively own over 50% of the vote or value of the corporation.

[2] *See* IRC Section 965(d)(1), (e)(1).

[3] *See* IRC Section 965(a).

[4] *See* IRC Section 951(a)(1). Although by its terms IRC Section 951(a)(1) only requires inclusion with respect to a controlled foreign corporation, IRC Section 965(e)(2) provides that a deferred foreign income corporation is treated as a controlled foreign corporation for purposes of IRC Section 951.

[5] *See* IRC Section 965(a). The TCJA originated in the House of Representatives and the House version of the bill was first introduced on November 2, 2017.

[6] *See* Or. Rev. Stat. §317.010(10) (corporations that file a federal separate return); Or. Rev. Stat. §317.715(1) (corporations that file or join in a federal consolidated return).

[7] *See* Or. Rev. Stat. §314.011(2)(b)(B) (providing so-called "rolling" reconnection to federal tax laws related to the definition of "taxable income").

[8] *See* OR Laws 2018, c. 101, s. 28. Although the issue is somewhat unclear, it appears that the change to Or. Rev. Stat. §317.267(1) only concerned the deemed repatriation. The same net reduction in apportionable income may arise with respect to global intangible low taxed income, commonly referred to as GILTI.

[9] The deemed repatriation generally is an income event for the 2017 tax year. However, if the foreign corporation has a tax year different from the affected U.S. shareholder, the deemed repatriation would apply to the 2018 tax year. *See* IRC Section 965(a) (Subpart F income increase occurs in "the last taxable year of a deferred foreign income corporation which begins before January 1, 2018"); IRC Section 951(a) (Subpart F income inclusion occurs when the taxable year of the non-U.S. corporation ends).

[10] *See* former Or. Rev. Stat. §314.665(4) (2015).

[11] *See* Or. Rev. Stat. §314.665(4).

[12] As described above, IRC Section 965 causes the deemed repatriation with a one-time increase in Subpart F income for "the last taxable year of a deferred foreign income corporation which begins before January 1, 2018." Accordingly, contrary to the Department's example, it is not possible for one corporation to have two deemed repatriations.

[13] Or. Rev. Stat. §316.048; *see also* Or. Rev. Stat. §316.007 (describing Oregon policy of matching federal taxable income).

[14] In contrast, OR Laws 2018, c. 108, s. 10, specially requires an addback of the IRC Section 199A deduction.

[15] Available at: http://listsmart.osl.state.or.us/pipermail/revenews/2018q1/000211.html.

[16] Qualified lump-sum distributions from certain qualified plans, on the other hand, demonstrate a situation in which an amount is deducted (i.e., not included in adjusted gross income on a federal income tax return), with a special tax calculated on IRS Form 4972, Tax on Lump-Sum Distributions, and that special tax amount added to federal tax due. Absent the Or. Rev. Stat. §316.737 addback, the federal government would tax such distributions but Oregon would not. The same does not apply to the IRC Section 965(c) DRD, none of which is taxed by the federal government.