# What's News in Tax

Analysis that matters from Washington National Tax

## Tax Reform: Recent Federal Proposals Revive Some Dormant State Issues

July 24, 2017

by Sarah McGahan, Alec Mullee, Shirley Sicilian, and Dan De Jong, Washington National Tax*

To reform, or not to reform? Although the Trump Administration and congressional Republicans continue to pursue tax reform, the process is inherently challenging. Most of these challenges arise at the federal level, of course. But some may arise at the state level, such as the dormant Foreign Commerce Clause of the U.S. Constitution, which restricts the states from favoring domestic over foreign commerce. The Import-Export Clause, which prohibits states from imposing imposts and duties on imports or exports, might also create issues. While the Foreign Commerce Clause and Import-Export Clause are not often raised in the state tax realm, certain features of federal tax reform proposals—such as the border tax adjustment and mandatory repatriation—may bring these constitutional clauses to the fore if the proposals become law and are adopted by states, either as a matter of choice or because of the manner in which the states conform to the federal IRC.[1] Thus, states may want to start considering these possible issues and implications.

*This article is intended to describe potential issues and to raise questions. It is not intended to reach any conclusions or to express a KPMG LLP position on any particular tax reform proposal.*

---

* Shirley Sicilian is a managing director in the State and Local Tax ("SALT") group of Washington National Tax ("WNT") and serves as the firm's National Director for State and Local Tax Controversy. Dan De Jong is a senior manager, Sarah McGahan is a director, and Alec Mullee is an associate in the WNT SALT group.

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended, (the "IRC") or the applicable regulations promulgated pursuant to the IRC (the "regulations").

## Foreign Commerce Clause

Under the Commerce Clause, Congress has the power "[t]o regulate Commerce with foreign Nations, and amongst the several states, and with the Indian Tribes."[2] While this clause contains no express limitations on a state's power to tax, the provision has been construed to contain an implied or dormant prohibition against certain state actions, including state taxes, to the extent they unduly burden or discriminate against interstate or foreign commerce. When state taxes affect commerce with foreign nations "a more extensive constitutional inquiry is required." The tax must satisfy the same constitutional requirements applicable to other state taxes—namely, the four requirements of the *Complete Auto* test[3]—plus two additional requirements: (1) the tax must not create a substantial risk of international multiple taxation and (2) the tax must not impair the federal government from "speaking with one voice when regulating relations with foreign governments."[4]

These requirements can invalidate certain features of a state tax structure, even when the features conform to, or merely flow through from, the federal tax structure. For example, in *Kraft General Foods, Inc. v. Iowa Department of Revenue,* the U.S. Supreme Court addressed whether Iowa's separate entity income tax scheme, which through conformity to the IRC allowed a dividends-received deduction for dividends received from domestic subsidiaries but not for dividends received from foreign subsidiaries, violated the Foreign Commerce Clause.[5] Applying the dormant Foreign Commerce Clause prohibition against favoring domestic commerce over foreign commerce, the Court held that it was indisputable that the Iowa statute treated dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries because Iowa required inclusion of the former and

---

[2] U.S. CONST. art. I, § 8, cl.3.

[3] Absent congressional approval, a state tax on interstate commerce will not survive Commerce Clause scrutiny if the taxpayer demonstrates that the tax (1) applies to an activity lacking a substantial nexus to the taxing State; (2) is not fairly apportioned; (3) discriminates against interstate commerce; or (4) is not fairly related to the services provided by the State. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

[4] Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 450 (1979). The Court in *Japan Line* applied the additional Foreign Commerce Clause criteria to invalidate a county-level property tax imposed on cargo containers owned, based, and registered in Japan. The containers on which the county sought to impose ad valorem property tax were used exclusively in international commerce, and were subject to tax on their full value in Japan. Thus, not only was there a risk multiple taxation would occur, but there was actual multiple taxation. Regarding the "one voice" principal, the Court found that federal government had articulated a policy desiring uniform taxation of containers utilized in foreign commerce (evidenced by the Customs Convention on Containers) and the imposition of property tax would likely lead to retaliatory taxes being imposed by Japan.

The Court more recently addressed the "one voice" principal in Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298, 320 (1994). In *Barclays*, the Court found that California's worldwide combined reporting regime as applied to foreign corporations did not violate the principal even though the federal government adopted a "separate accounting" method for income tax purposes and Congress was "aware that foreign governments were displeased with States' worldwide combined reporting requirements." Id. at 324. The Court noted that Congress did not act after the Court initially upheld worldwide combined reporting for domestic corporations even though it considered several bills to prohibit California's tax regime, which indicated "Congress' willingness to tolerate States' worldwide combined reporting mandates." Id. at 325-327.

[5] Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue, 505 U.S. 71 (1992).

not the latter in the calculation of taxable income.[6] The Court rejected several arguments made by Iowa in support of the proposition that its differential treatment did not constitute prohibited discrimination. For example, the Court found that Iowa's practice remained unconstitutional even if it did not favor Iowa-specific commerce over foreign commerce.[7] In other words, the Court held that a state cannot favor interstate commerce over foreign commerce. The Court also rejected Iowa's attempt at defending its practice on the grounds of administrative convenience, finding that the convenience of conforming to federal treatment did not rise to the level of a "compelling justification" for Iowa's discriminatory treatment of foreign dividends.

## The Import-Export Clause

The Import-Export Clause provides that "[N]o State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports . . ."[8] Unlike the implied or so-called dormant Foreign Commerce Clause, the Import-Export Clause contains an explicit limitation on the states' taxing power.[9]

The U.S. Supreme Court's most recent cases applying the clause to state taxes have focused on whether the challenged tax violates the three policy objectives underlying the Import-Export Clause, namely whether the tax (1) impeded the ability of the federal government to "speak with one voice" in implementing the nation's foreign relations, (2) resulted in the diversion of import revenues from the federal government to the states, or (3) caused interstate rivalry and friction (created when a state receiving imports taxes goods destined for other states).[10] The Court adopted this approach to the clause in *Michelin Tire Corp. v. Wages*, in which the Court upheld a Georgia county's ad valorem property tax—which applied to all property in the county—on tires and tubes imported by Michelin Tire from foreign countries.[11] The Court found that none of the three policy objectives was violated and the

---

6 *Id.* at 76.

7 *Id.* at 79.

8 U.S. Const., Art I, § 10, cl. 2.

9 In a Civil War era case, the Supreme Court held that the Import-Export Clause applied only to foreign imports and exports, not goods shipped between states. Woodruff v. Parham, 75 U.S. 123 (1868). However, in a 1997 dissent, Justice Thomas argued that the clause should also apply to commerce between the states. Justice Thomas says that, while "the 20th-century reader" may view "imposts or duties on imports or exports" as taxes on goods arriving from or leaving for foreign nations, "a strong argument can be made that for the Constitution's Framers and ratifiers—representatives of States which still viewed themselves as semi-independent sovereigns—the terms 'imports' and 'exports' encompassed not just trade with foreign nations, but trade with *other States* as well." Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 621 (emphasis in original) (1997). Justice Thomas then cites various examples of the terms being used to discuss trade among the states during the time the Constitution was being drafted, both in everyday life (advertisements, letters, etc.) and state statutes (e.g., a Virginia duty on cheese imported into the commonwealth from other countries and sister-states). Thomas also points out that when state legislators of the founding generation intended to limit the term "import" to only goods of foreign origin, they did so. However, the Import-Export Clause never so limited the term.

10 *See* Michelin Tire Corp. v. Wages, 423 U.S. 276, 285-86 (1976) and Dep't of Revenue of State of Wash. v. Ass'n of Washington Stevedoring Companies, 435 U.S. 734, 753 (1978).

11 Michelin Tire Corp. v. Wages, 423 U.S. at 278-80 (1976).

nondiscriminatory ad valorem property tax was "not the type of state exaction which the Framers of the Constitution . . . had in mind as being an 'impost' or 'duty'."[12]

The provision is actually not phrased as an outright ban on imposts or duties levied on imports and exports. Instead, the clause reads in full:

> No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports except what may be absolutely necessary for executing its inspection Laws: and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Control of the Congress.[13]

The Court has not directly addressed the meaning of the clause as a whole, so the significance of the additional language is unclear. Apparently, Congress can "consent" to state duties on imports beyond what is absolutely necessary for executing state inspection laws. However, it is less clear whether the "net Produce" of such duties must still go to the U.S. Treasury after congressional consent. It appears that Congress has never attempted to consent to a state tax under the clause.

## How These Constitutional Provisions Might Interact with Current Federal Reform Proposals

There are many moving parts to potential federal tax reform that have important implications for the states (immediate expensing, disallowance of net interest deductions, taxation of pass-through entities, etc.). Certain of these proposed changes may implicate the dormant Foreign Commerce and Import-Export Clauses, including, as mentioned above, the proposed border adjustment and required repatriation of deferred foreign earnings. If those clauses are implicated, states might be constitutionally prohibited from conforming to those features of tax reform.

However, Congress's power to "regulate" under the affirmative Commerce Clause includes the power to authorize state conformity to any federal tax reform. As for the Import-Export Clause, it appears that Congress can technically "consent" to state imposts or duties on imports, though it is less clear whether Congress can also remove the requirement that the state remit all such proceeds to the U.S. Treasury.

### *Border Adjustment*

A key part of the House Blueprint[14] is to include a "border adjustment" in a revised cash flow tax that would exempt exports from tax and impose tax on imports. The border adjustment, under the Blueprint, would most likely be implemented by excluding receipts from exports of products, services, and

---

[12] *Id.* at 283.

[13] U.S. Const., Art I, § 10, cl. 2.

[14] *A Better Way: Our Vision for a Confident America: Tax* (June 24, 2016) (the "Blueprint"), *available at* http://abetterway.speaker.gov/?page=tax-reform.

intangibles from the base of the federal tax and by disallowing the deduction of costs incurred in the acquisition of foreign inputs from the base, instead of an actual tax being imposed on imports.

The border adjustment proposed in the Blueprint has drawn a lot of comment–both positive and negative. However, after a recent speech on tax reform, it appears House Speaker Paul Ryan is still arguing for the concept.[15] Both Speaker Ryan and House Ways and Means Committee Chair Kevin Brady appear amenable to a phased-in border adjustment.[16] Nonetheless, support of the White House is unclear at best. President Trump's most recent (one page) tax reform proposal did not mention a border adjustment.[17]

If the border adjustment is enacted and states conform, either specifically or simply by conforming to the overall IRC, the dormant Foreign Commerce Clause may very well be implicated. A corporate taxpayer in the taxing state would receive a deduction for products, services, and intangibles obtained from a supplier in-state or in other U.S. states, but would not receive a deduction for these inputs if obtained from foreign suppliers. This could appear to be a case of favoring domestic commerce over foreign commerce, which is specifically prohibited by the dormant Foreign Commerce Clause as outlined by the U.S. Supreme Court. Under the Court's decision in *Kraft*, it may not matter that the taxing state was simply conforming to a federal provision that treats foreign inputs less favorably. Also per *Kraft*, it could be irrelevant that the taxing state is not necessarily incentivizing taxpayers to purchase goods in that particular state. Simply favoring domestic over foreign commerce is prohibited.

Conformity to the border adjustment feature of the Blueprint could also potentially violate the Import-Export Clause. A primary issue would be whether the denial of a deduction would qualify as an offending "impost" or "duty" on imports. On its face, denial of a deduction is not an "impost" or "duty" as those terms are commonly understood (i.e., an affirmative levy on imported commodities). Moreover, although imposts or duties are considered to be levied on goods, the import deduction would also apply to services and intangibles.[18] Still, to the extent that the border adjustment could be viewed as imposing an implicit tax on imported goods, it might violate the Import-Export Clause. In its 1976 opinion in *Michelin Tire*, the Supreme Court explained that imposts and duties "are essentially taxes on the

---

[15] KPMG, *House Speaker Ryan's "first major speech on tax reform* (June 20, 2017). While he did not explicitly call for a "border adjustment," he alluded to Blueprint, stating that: "Today, U.S. companies are leaving to become foreign companies, when it should be the other way around. . . . There are a number of ways to achieve this—we in the House have our own idea—and that is one of the things that we are discussing with the administration." *Id.* Although Ryan didn't mention the border-adjustable tax during his speech, he told reporters that the proposal is not dead. Asha Glover & Luca Gattoni-Celli, Tax Notes, *Ryan Urges Passage of Permanent Tax Reform by Year-End* (June 21, 2017).

[16] After his latest speech on tax reform, Speaker Ryan said: "We acknowledge, along with the administration, that in its present form — a fully phased-in, immediate, 100 percent, day one — you can't do that." Asha Glover & Luca Gattoni-Celli, Tax Notes, *Ryan Urges Passage of Permanent Tax Reform by Year-End* (June 21, 2017). During a June 13 conference, Rep. Brady said tax reform could include a five-year phase-in for the border adjustment. Dylan F. Moroses, Tax Notes, *Brady Proposes 5-Year Phase-In of Border-Adjustable Tax* (June 14, 2017).

[17] 2017 Tax Reform for Economic Grown and American Jobs (released Apr. 26, 2017).

[18] The Blueprint, p. 28.

commercial privilege of bringing goods into a country."[19] The denial of a deduction for only imported, and not domestic, inputs arguably fits within this description, thus making such an approach vulnerable to challenge under the Import-Export Clause. The Supreme Court has held on multiple occasions that an exemption or credit for favored persons is "no different in principal" from a tax on disfavored persons.[20] It would not take a large leap in logic to conclude that denying a deduction only for foreign imports is the same as a tax on those imports. After all, that is exactly the result the border adjustment is meant to achieve: it is meant to mimic the tax imposed on imports in value added tax countries.[21]

### *Repatriation of earnings*

The Blueprint proposes to move the U.S. tax system from one in which a U.S. resident individual or domestic domiciliary is taxed on its worldwide income (with taxation of overseas earnings deferred until the income is repatriated to the United States, and with a deduction or credit for taxes paid to foreign jurisdictions) to a territorial system that taxes only U.S.-sourced earnings to begin with. To accomplish this, the Blueprint proposes to provide a 100 percent exemption for dividends received by a U.S. entity from a foreign subsidiary. It also proposes to repeal most of the current "subpart F" regime that subjects certain income of controlled foreign corporations ("CFCs") to current taxation.[22] As a transitional move, the Blueprint would impose a "one-time" 8.75 percent tax on existing accumulated foreign earnings held in cash or cash equivalents and a 3.5 percent tax on all other accumulated foreign earnings (with companies paying the tax on repatriated earnings over an eight-year period).[23] The president has also proposed moving to a territorial system with a one-time mandatory repatriation (with the rate determined in consultation with Congress).[24]

It is unclear how any transitional mandatory repatriation would be implemented. However, recent experience suggests that Congress might accomplish the repatriation through the adoption of a

---

[19] Michelin Tire Corp. v. Wages, 423 U.S. 276, 287 (1976). "The characteristic common to both "imposts" and "duties" was that they were exactions directed at imports or commercial activity as such and, as imposed by the seaboard States under the Articles of Confederation, were purposefully employed to regulate interstate and foreign commerce and tax States situated less favorably geographically." *Id.* at 291-93.

[20] W. Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 211 (1994) (citing cases); *see also* CSX Transp., Inc. v. Alabama Dep't of Revenue, 562 U.S. 277, 287 (2011) ("our dormant Commerce Clause cases have often held that tax exemptions given to local businesses discriminate against interstate actors"). CSX Transportation also held: "To charge one group of taxpayers a 2% rate and another group a 4% rate, if the groups are the same in all relevant respects, is to discriminate against the latter. *That discrimination continues (indeed, it increases) if the State takes the favored group's rate down to 0%. And that is all an exemption is.*" Id. at 287 (emphasis added); *but see* Oregon Dep't of Rev. v. ACF Indus., Inc., 510 U.S. 332 (1994) (holding that an Oregon property tax imposed on railroad property did not discriminate against railroads under the 4-R Act despite having exemptions for various other, but not all, classes of commercial and industrial property).

[21] The Blueprint, p. 28 (June 24, 2016).

[22] The Blueprint suggests that foreign personal holding company rules governing the taxation of foreign passive income would remain in place.

[23] The Blueprint, p. 28 (June 24, 2016).

[24] KPMG, *Comparison of key aspects of president's tax plan, House GOP blueprint, Camp tax reform bill* (Apr. 28, 2017), citing to President Trump's tax plan, as described by Treasury Secretary Mnuchin and National Economic Council Director Cohn at a White House press conference on April 26, 2017.

dividends received deduction ("DRD"). The American Jobs Creation Act of 2004 adopted a one-time reduced rate on certain repatriated earnings. (Repatriation was optional under the Act.)[25] The reduced tax rate of 5.25 percent was accomplished by enacting a new IRC section, IRC section 965, which allowed a U.S. shareholder of a controlled foreign corporation to elect, for one tax year, to apply an 85 percent DRD with respect to cash dividends received from its CFCs. Former Ways and Means Committee Chairman Dave Camp introduced a tax reform bill in 2014 that included a move to a territorial tax system with a mandatory repatriation of foreign earnings on which U.S. tax had been previously deferred. Like the Blueprint, the 2014 bill included an 8.75 percent tax on existing accumulated foreign earnings held in cash or cash equivalents and a 3.5 percent tax on all other accumulated foreign earnings.[26] These rates were to be achieved through a DRD similar to the temporary DRD allowed under IRC section 965.[27] In fact, the 2014 bill aimed to implement mandatory repatriation by amending IRC section 965.[28]

After the Supreme Court made clear in *Kraft* that states may not subject foreign dividends to a greater tax burden than dividends from domestic entities, many states that had simply conformed to the federal DRD regime were forced to decouple or otherwise fix their laws to address the federal discrepancy between treatment of foreign and domestic dividends. State responses varied from expanding the state DRD to include foreign dividends and deemed dividends to simply excluding foreign dividends from the state tax base. Although states, at this point in time, should have solved their "*Kraft"* issues with respect to the state tax treatment of foreign source dividends, a state could still have an issue if their *Kraft* fix did not extend to deemed foreign dividends. Furthermore, although states ostensibly had to address this issue when IRC section 965 was adopted as part of the American Jobs Creation Act of 2004, a state's section 965 fix (assuming there was one) may or may not encompass any 2017 tax reform-related DRDs. Illinois, for example, was one state that specifically amended its tax laws to capture IRC section 965 deemed dividends. The state previously allowed a DRD for deemed dividends per IRC sections 951-964, but eventually amended its statute to specifically include section 965 deemed dividends.[29] Timing might be an issue if tax reform is enacted and effective retroactively or almost immediately, as states may not have a chance to amend their laws to "fix" any constitutional issues that arise as a result of the states DRDs not capturing repatriated deemed dividends.

Some states have distinguished *Kraft* from the situation in which a DRD applies only to domestic dividends in a state that requires water's-edge combined reporting. In this situation, certain courts have determined that because the apportioned earnings of the domestic subsidiaries are taxed as income of the unitary business, the dividends themselves should not be subject to taxation again—hence the DRD. At the same time, because the income of foreign subsidiaries is not taxed in a water's-edge state, these courts have reasoned that no discrimination results from taxing, in whole or in part, dividends

---

[25] American Jobs Creation Act of 2004 (P.L. 108-357), § 422; codified as IRC § 965.

[26] Similar to the Blueprint, companies would be able to pay the tax on repatriated earnings over an eight-year period.

[27] The 3.5 percent tax was achieved through a 90 percent DRD and the 8.75 percent tax was achieved with a 75 percent DRD.

[28] *See* H.R. 1, sec. 4003 (113th Congress).

[29] HB 2955 (2011), amending 35 ILCS §5/203(b)(2)(O).

derived from foreign subsidiaries.[30] In this situation, the "disparate treatment of foreign and domestic dividends is necessary to produce a kind of taxing symmetry."[31] While the issue has not been directly addressed by the U.S. Supreme Court, a number of state courts have found no violation of the Foreign Commerce Clause under these circumstances, relying in part on a footnote in *Kraft* that suggested that the holding might have been different in a combined reporting regime.[32] Assuming mandatory repatriation took the form of an IRC 965-type deemed dividend, in states that have water's-edge combined reporting, this issue could reemerge with increased significance.

## Conclusion

Although tax reform is still far from certain, this article highlights a few issues that states will need to consider if a border adjustment or mandatory repatriation with reduced rates is enacted as part of a tax reform package. The issues associated with repatriating deemed dividends are familiar to the states and tax practitioners: They have come up previously. The potential Foreign Commerce Clause and Import-Export Clause issues associated with the border adjustment arguably could be more serious. The border adjustment is a cornerstone of the Blueprint's proposed revised cash flow tax. While Congress could remove any Foreign Commerce Clause obstacle to state conformity, addressing the sweep of state revenue into the U.S. Treasury that is apparently mandated by the Import-Export Clause seems trickier. If states are compelled to decouple from this key component of a revised federal corporate tax system, the existing disconnect between state and federal taxation would grow even more pronounced and complexities would increase for states and state taxpayers as a result. This might compel states to look for alternative forms of taxing corporations, such as adopting gross receipts taxes, or simply remaining attached to the former federal net income regime for taxing corporations. Furthermore, at least one of the goals behind the border adjustment—to encourage companies to purchase domestically—would be somewhat thwarted if states cannot conform.



[30] Emerson Elec. Co. v. Tracy, 735 N.E.2d 445 (Ohio 2000).

[31] *Id.*

[32] *See, e.g.*, In re Morton Thiokol Inc., 864 P.2d 1175 (1993); El Du Pont de Nemours & Co. v. State Tax Assessor, 675 A.2d 82 (Me. 1996); *but see* Emerson Elec. Co. v. Tracy, 735 NE.2d 445 (Ohio 2000) (finding the DRD for Ohio's combined reporting regime violated the Foreign Commerce Clause and distinguishing the other cases on the grounds that Ohio permits exclusion of domestic corporations from the combined group).