This Week in State Tax (TWIST)

September 30, 2024

Oregon: Tax Court Approves Partial Factor Representation for Repatriation Income

The Oregon Tax Court recently addressed the sales factor treatment of repatriation income under Internal Revenue Code section 965 that was included in Microsoft's Oregon taxable income. Recall, the Tax Cuts and Jobs Act of 2017 (TCJA) required the shareholders of certain controlled foreign corporations (CFCs) to include the accumulated earnings and profits of the CFCs from 1986 through 2017 on their 2017 federal tax return (repatriation amount) and subjected it to a 10 percent federal tax. On its Oregon return, Microsoft deducted 80 percent of the federal repatriation amount pursuant to Oregon's "dividends-received" subtraction and included the remaining 20 percent in its pre-apportionment taxable income. On its original return, Microsoft excluded any repatriation income from its sales factor, based on a 2018 Oregon Department of Revenue Bulletin. Microsoft subsequently filed an amended return, including the 20 percent repatriation amount in its sales factor denominator. The Department denied the resulting refund request, and Microsoft appealed, arguing that inclusion of the 20 percent repatriation amount in the sales factor was appropriate under the Tax Court's previous decision in *Oracle II*. Microsoft also argued on appeal that it is entitled to another form of factor representation because the statutory apportionment method failed to fairly represent the extent of Microsoft's business activity in Oregon and was unconstitutional.

In its decision, the court agreed with Microsoft that it was entitled to include the 20 percent repatriation amount in its sales factor denominator. Under the law for the relevant tax year, the sales factor "excludes gross receipts arising from the … holding of intangible assets … unless those receipts are derived from the taxpayer's primary business activity." In *Oracle II*, the court interpreted this language to mean that Subpart F income should be included in the sales factor so long as the water's edge group was engaged in a unitary business with the CFC that generated the income. In the court's view, many of Microsoft's CFCs were engaged in similar "primary" business activities abroad as the Microsoft water's edge group engaged in domestically. The court further determined that there was sharing and exchange of value among all the corporations, and the only reason the earnings and profits of the CFCs were not included in federal taxable income prior to the enactment of IRC section 965 was because Congress had not required the amounts to be included as Subpart F income and the directors of the CFCs had not chosen to pay the amounts as dividends to the shareholders.

Note that the court's conclusion to allow for the inclusion of the 20 percent repatriation amount in the sales factor did not result in a refund of the full amount claimed by Microsoft as part of its appeal. Microsoft had also argued that it was entitled to deviate from Oregon's statutory apportionment formula under an alternative apportionment theory. In filings, the taxpayer had articulated three possible methods of providing alternative factor representation to better reflect the activities of the entities giving rise to the included repatriation income: including

KPMG

This Week in State Tax (TWIST)

September 30, 2024

20 percent of all CFC sales in the sales factor denominator; including 100 percent of the deemed repatriation in the sales factor denominator; or use of separate accounting. The court ultimately rejected Microsoft's factor representation argument finding that the taxpayer failed to meet its burden of proof to demonstrate that the Oregon apportionment did not fairly represent its business activities and that the statutory method was unconstitutional. In the court's view, Microsoft failed to show that including the 20 percent repatriation amount did not provide sufficient factor representation considering the 80 percent dividends received deduction and the portion of the repatriation amount included in the denominator of the sales factor. The court also rejected Microsoft's argument that the statutory formula violated the Commerce Clause and the Due Process Clause. Please contact Nisha Mathew for questions about *Microsoft Corp. v. Oregon Department of Revenue*.