Federal Tax Reform – How Have the States Reacted So Far?

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Agenda

- **Overview of State Tax Conformity with the Tax Cuts and Jobs Act**
- **Key Domestic Tax Provisions Impacting the States**
- **Key International Tax Provisions Impacting the States**

Overview of State Tax Conformity with the Tax Cuts and Jobs Act

Key Tax Law Changes in the TCJA and Differences from the Tax Reform Act of 1986

- **Revenue Neutral vs. Deficit Financed**
  - The Tax Reform Act of 1986 provided for about $120 billion of PIT cuts financed by about $120 billion of CIT increases.
  - The Tax Cuts and Jobs Act (P.L. 115-97) (TCJA) provides for $6 trillion over 10 years of tax cuts and only $4.5 trillion over 10 years of tax increases.
- **Transformational Changes**
  - 40 percent corporate tax rate cut to sync up with OECD norms.
  - Lower PIT rate – and pass-through deduction for individuals.
  - Broad new limitations on the interest deductions.
  - Bonus depreciation and immediate expensing.
  - $10k limitation on state and local tax deductions for individuals.
- **International Tax Reform**
  - Moves the U.S. from a worldwide to a quasi-territorial tax system consistent with U.S. trading partners.
  - New foreign source tax provisions intended to raise revenues (to offset tax cuts) and tilt the playing field to favor domestic commerce over foreign commerce (e.g. GILTI; BEAT, FDII).

Top Increases and Decreases in Federal Corporate Tax Base with TCJA and Potential State Conformity

Business Tax Provision	% Change in Federal Corporate Tax Base	State Conformity
One-time transition tax on unrepatriated foreign earnings	+ 9 %	Partial conformity (but typically of 25% or less)
Net interest expense limitation (30% of ATI)	+ 6.4%	Mostly conformity
Global intangible low-taxed income (GILTI)	+ 5.5 % (gross)	Mostly conformity
Modification of net operating loss deduction	+ 5.3%	States have own provisions
Base Erosion and Anti-Abuse Tax (BEAT)	+ 4.0%	Non-conformity
Amortization of research and experimental expenditures	+ 2.9%	Conformity
Repeal of domestic production activities deduction	+ 1.9%	Partial conformity
Foreign derived intangible income (FDII) deduction	- 1.7%	Mostly conformity (but §250 issue)
Expensing provided under Section 168(k) bonus depreciation	- 1.8%	Limited conformity
Global intangible low-taxed income (GILTI) deduction	- 2.6%	Mostly conformity (but §250 issue)
100% foreign DRD	- 5.9%	States have own provisions

Quantifying the impacts of TCJA on state corporate taxes

- The EY/COST/STRI study provides estimates of the impacts of TCJA on state corporate tax bases.
- Study examines the impact of all states updating their corporate tax codes to the TCJA, but remaining coupled to specific provisions as they have in the past.
- The estimated percentage change in the state corporate tax base from TCJA is about 12% over the first 10 years (2018-2027), with significant variation among the states.

Key Domestic Tax Provisions Impacting the States

Interest Expense Limitation – IRC § 163(j)

- **General Overview**: Business interest expense cannot exceed 30% of FTI exclusive of business interest income, business interest expense, depreciation, amortization.
- **State Tax Issues**:
  - How is the limitation computed for state purposes when state and federal filing methodologies differ?
    - Conformity to consolidated return regulations
  - External vs. internal debt (especially for separate return jurisdictions).
  - Will state allow indefinite carryforward of disallowed interest expense?
  - How will the federal limits interact with state related party interest expense disallowance statutes?

100% Bonus Depreciation – IRC §168(k)

- **General Overview**: Current bonus depreciation percentage under IRC §168(k) is increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before December 31, 2022. The 100% expensing is phased down by 20 percentage points per calendar year beginning in 2023.
- **State Tax Issues**:
  - Will states conform?
  - States that historically decoupled from bonus, will likely decouple from the increase to 100%
  - Straight coupling to federal vs. MACRS vs. different approaches
  - Tracking different methods in different states

Personal Income Tax Issues

- **State conformity with the deduction for pass through entities.**
  - Impact limited to a minority of states with PIT tied to federal "taxable income"
- **Federal limitation on state and local tax deduction has caused some states to respond with novel proposals**
  - Optional employer payroll tax with employee "credit" for wages subject to payroll tax
  - State-sponsored "charities" to provide essential governmental services
  - Tax on traditional pass-through entities
  - State suits against the federal government for intruding on state sovereignty
- **Change in personal exemptions**
  - Zeroed out the amount – but leaves the number determination

Key International Tax Provisions Impacting the States

IRC §965(a) Mandatory One Time Deemed Repatriation (Transition Tax)

- **IRC §965(a) provides for a one-time mandatory deemed repatriation of 30 years of accumulated foreign earnings.**
  - The IRC §965(a) provisions are effective in 2017.
  - The transition tax is reported on a new federal form created specifically for the one-time deemed repatriation, and is not reported as part of the regular federal taxable income.
  - The transition tax can be paid in installments over eight years.

- **About one-third of the states currently conform to the transition tax based primarily on prior treatment of foreign dividends or Subpart F income.**

Transition Tax State Issues

- **Apportionment and factor representation issues.**
  - As the “deemed” dividends represent 30 years of earnings, what would adequately provide factor representation?
  - Over the 30 years encompassed in the mandatory “deemed” dividends period, a U.S. Corporation’s footprint in any given state may have changed significantly, and the state’s method of apportionment (3FF, SSF) and tax rate may have changed significantly.
- **Earnings and profits are netted at the federal consolidated group level. This presents unique issues in separate entity states and states where the filing group differs from federal.**
  - Should the federal net earnings and profits be allocated among the group members?
  - Should taxpayers prepare separate E&P calculations based on the state filer, which could result in state specific “deemed” dividends different than the federal amount?
- **If all mandatory repatriated income is excluded, will the state disallow expenses associated with the income?**

Global Intangible Low-Taxed Income (GILTI)

- **GILTI is a new annual federal calculation intended to ensure a minimum tax is paid on worldwide income and is effective in 2018.**
- **Three components are used in the federal GILTI calculation:**
  - **IRC §951A:** Includes all global income earned by the taxpayer's foreign subsidiaries. Makes assumption on how much is intangible based on a set rate of return on tangible assets.
  - **IRC §250(a)(1)(B)):** Provides an offsetting deduction to lower the effective tax rate.
  - **Foreign Tax Credits**: Finally, a credit is provided for 80% of taxes paid to foreign jurisdictions on the GILTI income, which ensures only low-taxed foreign income is subject to federal taxation. Generally, a taxpayer will not be subject to residual U.S. tax if the average foreign tax rate imposed on such income is at least 13.125%.
- **To date, 10 states have decoupled from GILTI.**

Is the Impact of GILTI different for State Tax Purposes than for Federal Tax Purposes?

- **Global:** Yes, it includes all of the global income earned by the taxpayer's foreign subsidiaries from conducting active trade or business.
- **Intangible:** No, it includes income from services, intangible property, and a portion of tangible property
- **Low-Taxed:** No, the states do not conform to the (80%) foreign tax credit allowed for federal tax purposes to offset the GILTI income. In addition, many of the states may not conform to IRC Section 250 that allows for a 50% deduction for GILTI income.
- **Offset by Corporate Tax Cuts**: No, states do not conform to federal corporate tax cuts (Congress is raising $324 billion over 10 years from the international tax provisions to help pay for $654 billion in business tax cuts).

GILTI: SALT Implications

- **Factor Representation relating to the inclusion of GILTI income:**
  - Will factor representation be allowed?
  - If so, will the sales factor be based on GILTI "net" income, gross foreign receipts, gross foreign receipts allocated by GILTI income, or some other formula?
- **State income tax conformity with GILTI (and other FTR provisions) may result in a number of constitutional challenges:**
  - Is the controlled foreign corporation (CFC) unitary with the U.S. filer?
  - Discrimination against foreign commerce in favor of domestic commerce (e.g. the *Kraft* precedent)?
  - Factor representation: Is the inclusion of foreign income without corresponding apportionment factors of the CFCs unconstitutionally discriminatory?