

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 International Tax Provisions Impacting the States**
- **Key Domestic 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).

State Partial Conformity with the TCJA

– Impact of the TCJA on Corporations:

- A federal tax cut of about 10%.
- A state tax increase of about 12%.
 - COST/ EY study “The Impact of Federal Tax Reform on State Corporate Income Taxes” (based on 2018 update and pre-federal tax reform (FTR) linkage to IRC).

– This outcome is typically inadvertent: if states simply conform to the TCJA, either automatically or by updating the conformity date, and do nothing more they will link to federal corporate base-broadening measures, but not to federal tax rate reductions.

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

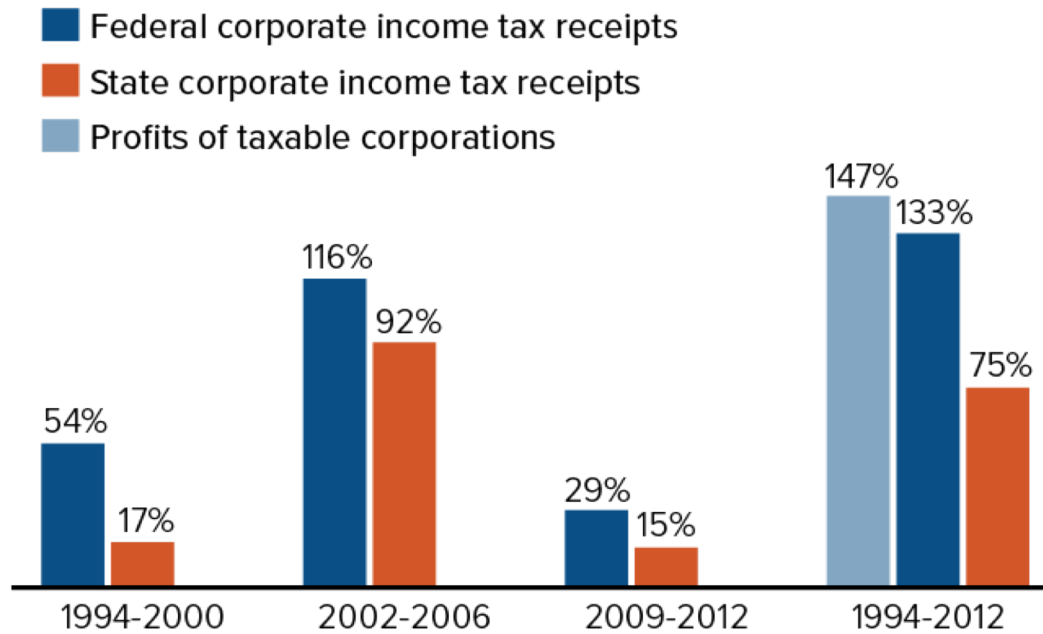
Business Tax Provision	% Change in Federal Corporate Tax Base	State Conformity
One-time transition tax on unrepatriated foreign earnings	+ 9 %	Partial conformity (but typically of 25% or less)
Net interest expense limitation (30% of ATI)	+ 6.4%	Mostly conformity
Global intangible low-taxed income (GILTI)	+ 5.5 % (gross)	Mixed 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%	Mixed conformity
Expensing provided under Section 168(k) bonus depreciation	- 1.8%	Limited conformity
Global intangible low-taxed income (GILTI) deduction	- 2.6%	Mixed conformity (but §250 issue)
100% foreign DRD	- 5.9%	States have own provisions

State Tax Budget Considerations

- **Anticipated state tax revenue increases from the Wayfair decision, conformity with the TCJA, and a sustained economic recovery**
 - \$8 billion to \$33 billion estimated annual sales tax revenue increase (cited in SCOTUS Wayfair decision)
 - \$6 to \$8 billion estimated annual state corporate income tax revenue increase from state conformity with the TCJA (COST/EY study)
- **The federal limitation on the state and local tax deduction is a significant concern for many states, particularly those along both coasts.**
- **Looming federal deficit/debt crisis may limit federal revenue sharing with the states in the long-term**
 - The CBO projects the federal debt will increase to \$33 trillion in 2028, a higher level than any point since just after WWII.
 - 33% of all state and local revenue comes from federal funds.
- **Some states have structural budget gaps arising from pension liabilities, infrastructure needs and rising health care costs**

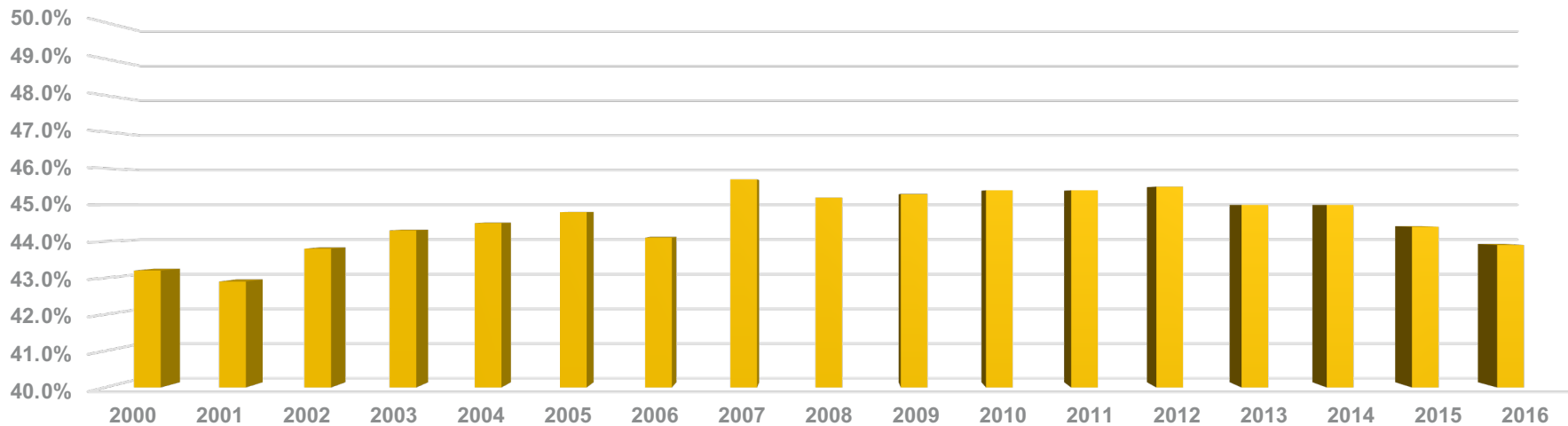
State corporate tax receipts have significantly lagged federal receipts

Percent change over time, 1994-2012



Source: U.S. Census Bureau; Internal Revenue Service.

Share of State and Local Taxes Paid by Businesses



Source: Council On State Taxation and Ernst & Young, *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2016*, Aug. 2017.

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.
 - IRC §965(c) reduces the federal tax rate on repatriated earnings to 15.5% for earnings of cash and cash equivalents and 8% for all other earnings.
 - 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 (in part) to the transition tax based primarily on prior treatment of foreign dividends or Subpart F income.**

Transition Tax State Issues

- **Will states adopt the 965 (c) tax rate reduction?**
- **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?
- **If all mandatory repatriated income is excluded, will the state disallow expenses associated with the income?**
- **Should states allow taxpayers 30 additional days to file 2017 returns or provide a penalty waiver?**

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%.

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 significant income from services, digital products, intangible property, and a portion of tangible property sales
- **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)?
 - Differences between separate reporting and combined reporting states
- Is the inclusion of foreign income without corresponding factor representation unconstitutionally discriminatory?

GILTI: A Trend toward Decoupling?

— Decoupling (to date) from GILTI

- Connecticut (by regulatory guidance)
- Georgia (SB 328)
- Hawaii (SB 2821)
- Indiana (HB 1316)
- Kentucky (by regulatory guidance)
- Michigan (SB 748)
- North Carolina (SB 99)
- Wisconsin (AB 259)
- Illinois (no conformity due to preexisting law)
- Montana (no conformity due to preexisting law)
- South Carolina (no conformity due to preexisting law)

Foreign Derived Intangible Income (FDII): IRC §250

- Provides a 37.5% deduction for certain income earned in the U.S. attributed to foreign sales relating to U.S.-held intangibles.
 - Results in a reduced effective tax rate on covered income of 13.125%, subject to a taxable income limitation (16.40625% after 2025).
- FDII is calculated in a manner similar to GILTI. Returns in excess of 10% of fixed assets form the basis for the calculation.

FDII: SALT Implications

- Deduction for FDII under IRC § 250 is likely a “special deduction,” thus the impact (benefit) may be dependent on whether a state’s starting point for calculation of state taxable income is Form 1120 line 28 or line 30.
- The impact of FDII will be affected by a taxpayer’s state income tax filing method.
- Selective decoupling – FDII, as enacted, is designed to work with GILTI.

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