TCJA Impact on the States: Major Issues and Status Report on De-Coupling Efforts

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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
- Other Highlights of the Impact of TCJA on States
- Caveat: any opinions expressed during the presentation are those of the panelist and not necessarily his employer or SEATA.

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

Key Tax Law Changes in the Tax Cuts and Jobs Act

- **Lower Tax Rates**
  - Federal Tax Reform (FTR) includes a reduction in individual income tax rates as well as in corporate tax rates (40 percent cut).
- **Base Broadening**
  - Lower rates are significantly (although not wholly) offset by a wide range of base broadeners extending to both individual and business taxation.
- **International Tax Reform**
  - FTR shifts the U.S. from a worldwide residence-based tax system toward a territorial tax system. It imposes a one-time transition tax on previously untaxed accumulated foreign earnings. FTR also introduces a number of new tax provisions intended to tilt the playing field to favor domestic commerce over foreign commerce.

State Partial Conformity with the TCJA

- **Potential Impact of the TCJA on Corporations:**
  - A federal corporate tax cut of about 10%.
  - A state corporate tax increase of about 12% (assuming conformity with TCJA based on pre-federal tax reform (FTR) linkage to IRC).
    - COST/STRI/ EY study “The Impact of Federal Tax Reform on State Corporate Income Taxes”.
- **Biggest potential state corporate tax increases**
  - IRC §965 repatriation tax: generally 1 to 4 percent
  - GILTI (IRC §951A): 5.5 percent (or 2.9 percent with IRC §250 deduction)
  - IRC §163(j) interest expense limitation: 6.4 percent

Potential State Impact of Business Tax Reform Provisions

Federal	States
Corporate tax rate reductions	States have own rates
Special pass-through entity deduction	Potentially impacts minority of states tied to federal "taxable income" for PIT purposes
Limitation of net interest deductions that exceed 30% of adjusted taxable income	State conformity (uncertain application to state filing groups)
Fully expensed investments	2/3 of states opted-out of bonus depreciation last time
Broadened tax base including repeal of Sec. 199 domestic production deduction	State conformity (although many states already opted out of the domestic production deduction)
Limit NOL deductions	Most states have their own NOL provisions
Amortization of research and experimental expenditures	State conformity

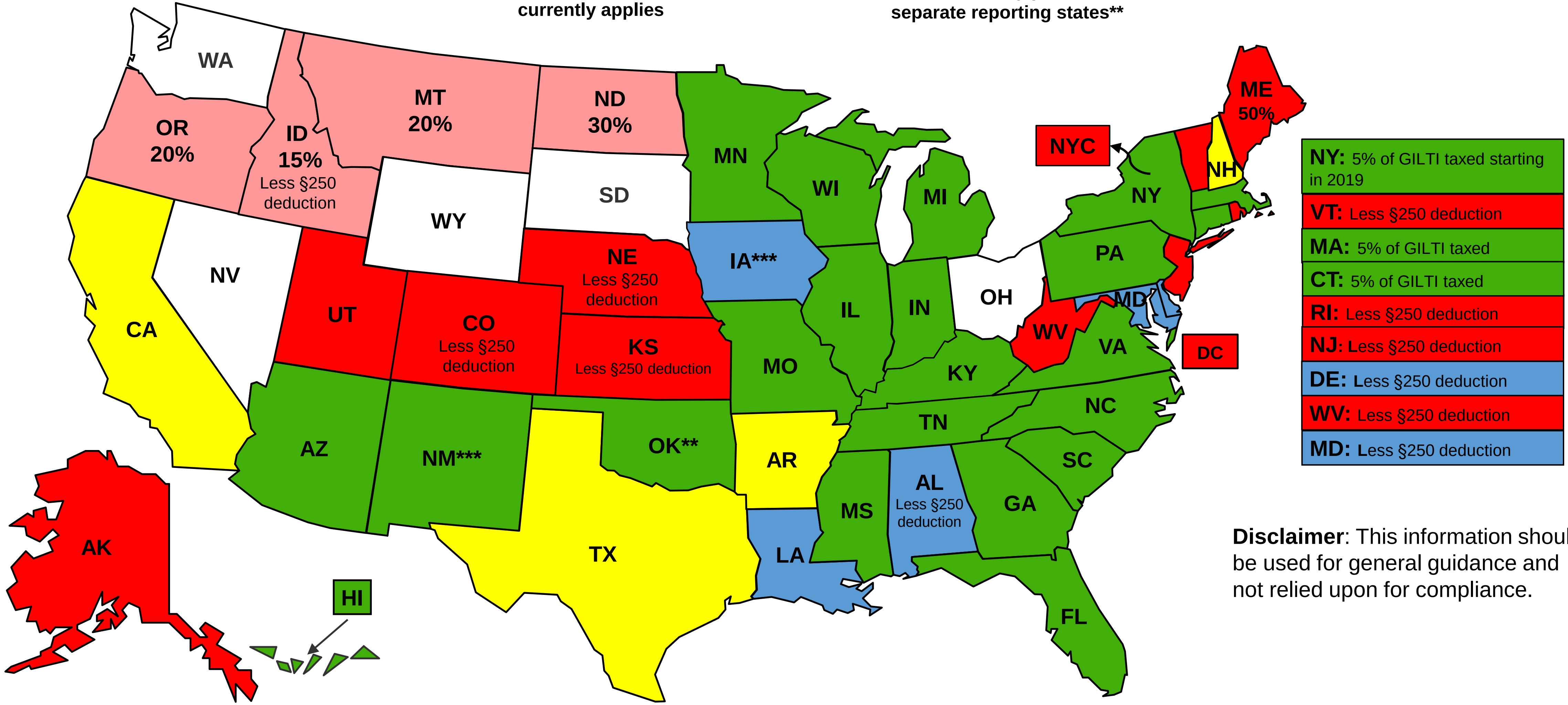
Potential State Impact of International Tax Reform Provisions

Federal	States
100 percent dividends-received deduction	Most states have their own DRDs
Transition tax on “deemed” repatriated earnings	One-third of states tax some portion of Subpart F income and/or foreign dividends.
Tax on global intangible low-taxed income (GILTI) earned by CFC	Likely state conformity (but constitutional issues)
Deduction of 50% of GILTI income	Partial state conformity (but “special deduction” linkage issues)
Reduced tax on foreign-derived intangible income (FDII) of U.S. corporation	Partial state conformity (but “special deduction” linkage issues)
Base erosion anti-avoidance tax (BEAT)	Separate tax not in federal taxable income base
Longer amortization schedule for foreign research and experimentation (15 years)	Likely state conformity (but constitutional issues)

Key International Tax Provisions Impacting the States

State Corporate Income Tax Conformity to GILTI*

- State does not impose a corporate income tax
- Decoupled from GILTI (or excludes 95%)
- Have not addressed IRC conformity and/or GILTI coupling specifically. Neither GILTI nor § 250 deduction currently applies
- Potentially coupled to GILTI, but inclusion may be constitutionally prohibited in separate reporting states**
- Coupled or potentially coupled to 10% to 30% of GILTI**
- Coupled or potentially coupled to GILTI**



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Note: Those states with "less §250 deduction" only tax 50% of GILTI (or 62.5% after 2025).

* Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or state personal income tax (PIT) purposes.

** GILTI is not specifically referenced in many state conformity statutes so some states may still decouple from some or all of GILTI by administrative/legislative action.

*** Iowa conformity begins in 2019. New Mexico decouples starting in 2020.

Source: Council On State Taxation

Is the Impact of GILTI the Same for State Income Tax Purposes as It Is for Federal Income Tax Purposes?

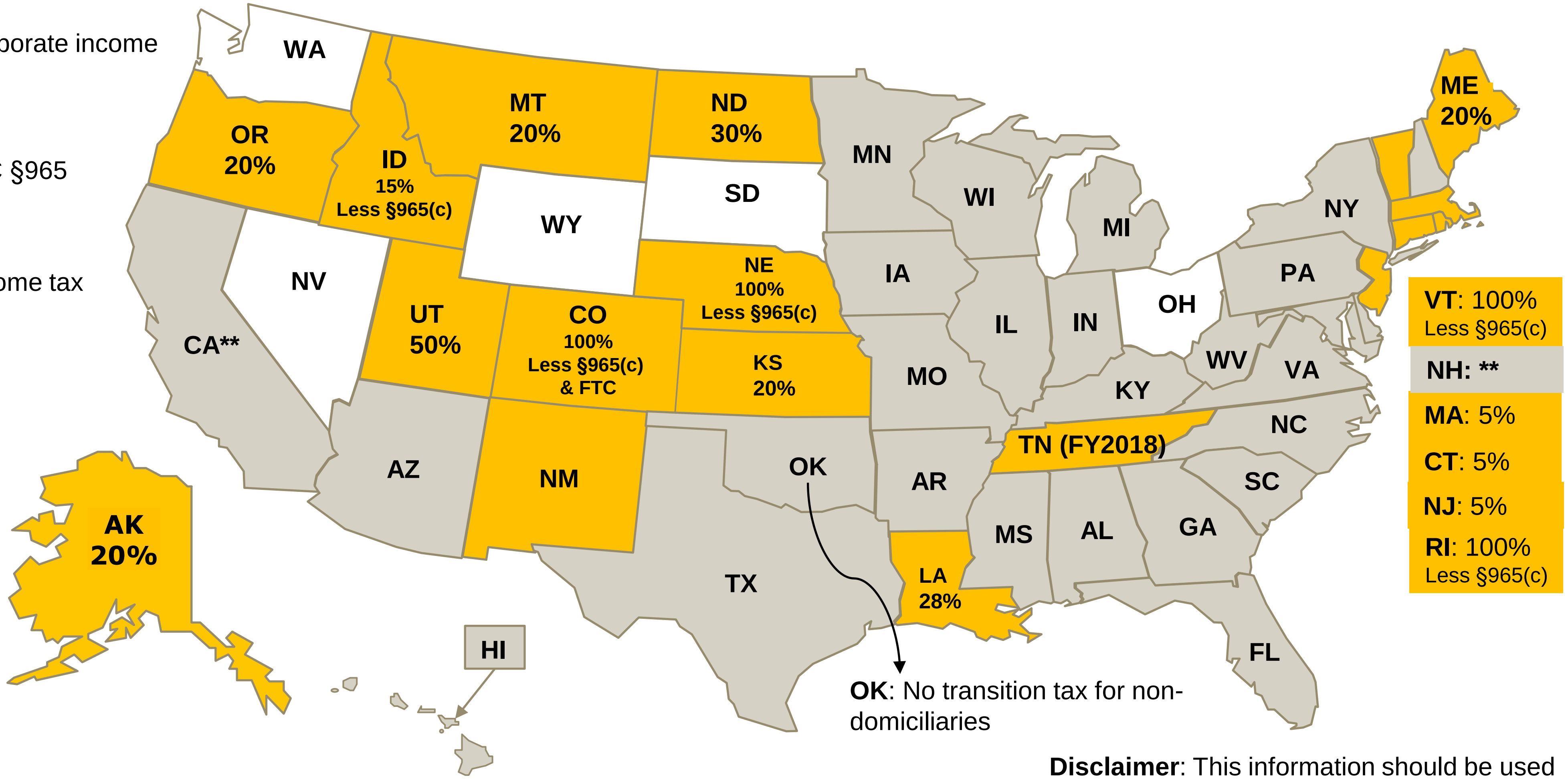
- **Global:** Yes, its starting point is all of the global income earned by the taxpayer’s foreign subsidiaries.
- **Limited to Intangibles**: This is a misnomer – GILTI (global intangible low-taxed income) includes income from services, digital products, financial services, a sizable portion of tangible property sales, and intangibles.
- **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 (reduced to 37.5% after 2025) 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).
- **Favor Domestic Commerce over Foreign Commerce:** No, the states are limited by the Constitution’s Commerce Clause and cannot treat foreign commerce differently than domestic.
- **On whether states should decouple from GILTI,** see generally: Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroian, and Chelsea A. Wood, “State Taxation of GILTI: Policy and Constitutional Ramifications,” *State Tax Notes*, October 22, 2018.

State Corporate Income Tax Conformity to IRC §965 Repatriated Income*

State does not impose a corporate income tax

0%: State does not impose corporate income tax on IRC §965 repatriated income

State imposes corporate income tax on some or all of IRC §965 repatriated income



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* Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or PIT purposes.

**No conformity update but taxes a portion of foreign dividends (when distributed) for water's edge filers.

Source: Council On State Taxation

Foreign Derived Intangible Income (FDII): IRC §250

- **General Overview**: Provides a 37.5% deduction (decreased to 21.875% after 2025) for certain income earned by a U.S. domestic corporation attributed to foreign sales relating to U.S. production.
  - Results in a reduced federal 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. Conformity may depend on whether a state's starting point for calculation of state taxable income is Form 1120 line 28 or line 30.
- **State Tax Issues**:
  - Modest State Conformity – approximately one dozen states have conformed to FDII.
    - Selective decoupling – FDII, as enacted, is designed to work with GILTI.
  - The impact of FDII will be affected by a taxpayer's state income tax filing method.
  - How will states apportion FDII.
    - See onerous New Jersey apportionment rule for FDII.

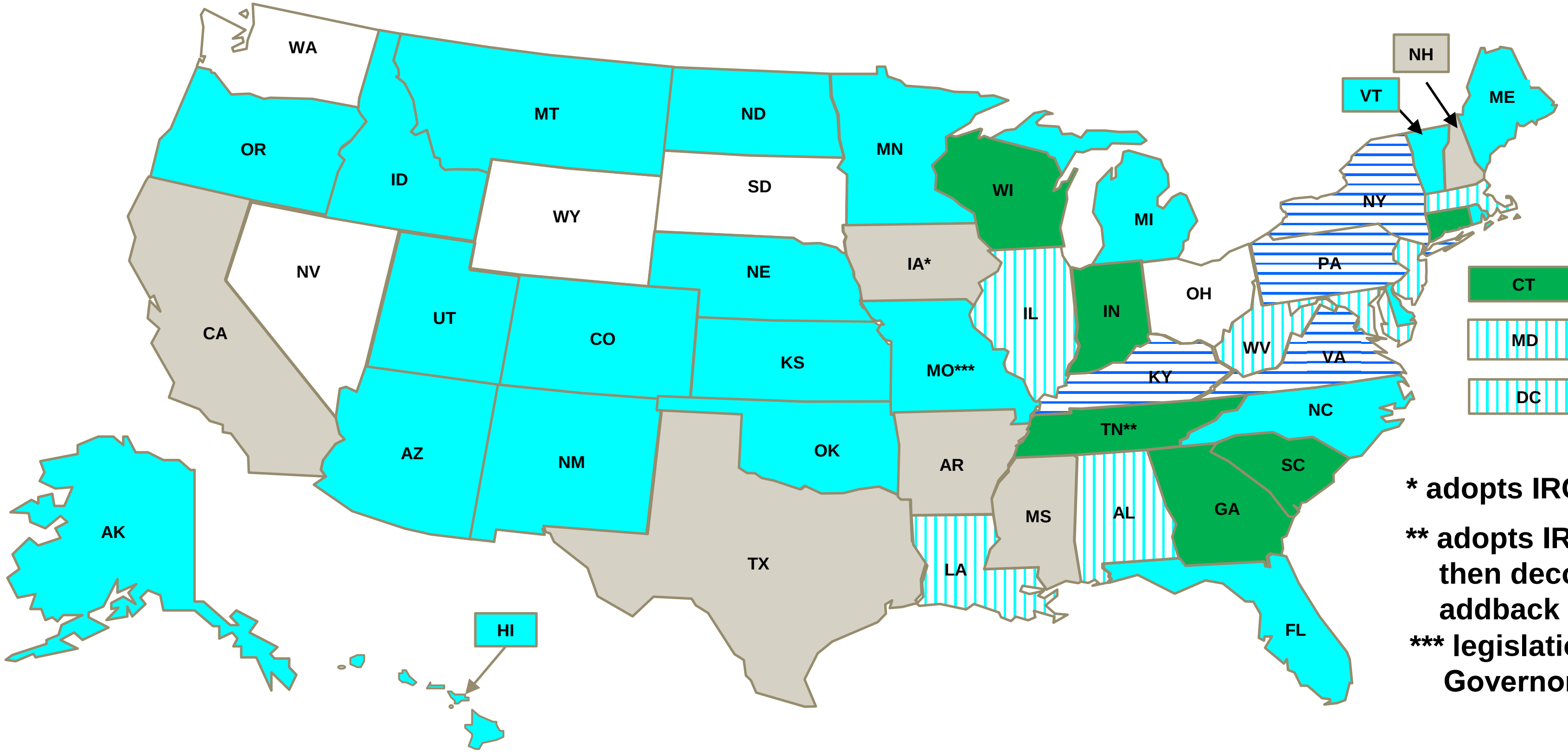
Future Litigation over State Taxation of GILTI and IRC §965 Repatriated income

– **Separate reporting states: Can the foreign source income be taxed at all?**
  - See *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992). A separate reporting state may not tax dividends from a controlled foreign corporation if it does not tax dividends from a controlled domestic corporation.
  - Seven separate reporting states are still coupled to GILTI (down from 11 in late 2018).

– **Combined reporting states: Can the foreign source income be taxed without appropriate factor representation (or a unitary relationship)?**
  - Per COST, the state taxation of GILTI (and IRC §965 repatriated income) in combined reporting states likely violates Commerce Clause limitations unless appropriate foreign "factor representation" is allowed.
  - The argument will likely focus on "discrimination" and not on "undue burden." See *Oregon Waste Systems Inc. v. Department of Environmental Quality of Oregon,* 511 U.S. 93 (1994)
  - See contra:
    - *E.I. du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Maine 1996); and
    - *Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993).

Key Domestic Tax Provisions Impacting the States

State Conformity to 30% Interest Expense Limitation



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*** adopts IRC §163(j) in 2019**

**** adopts IRC §163(j) in 2018 and 2019, then decouples. State has interest addback**

***** legislation to decouple pending Governor's signature**

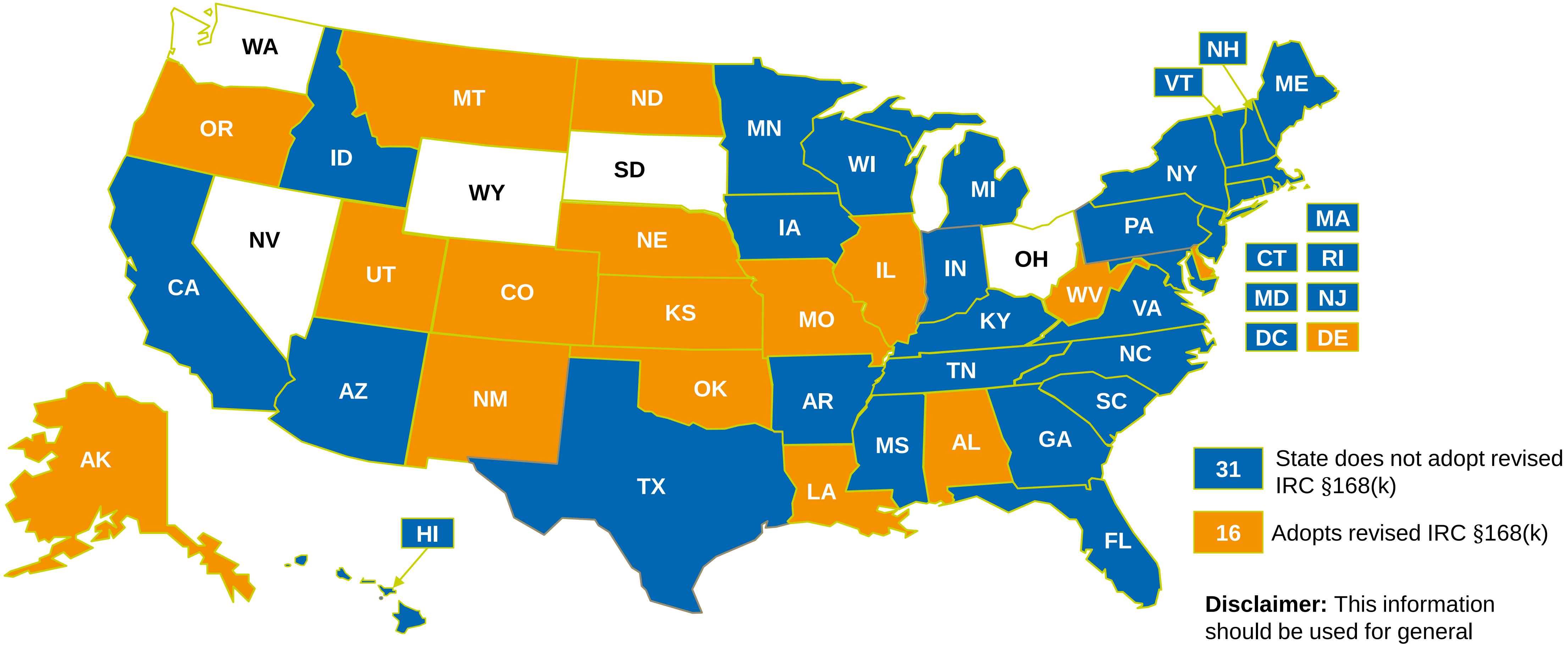
5	**No General Corporate Income Tax**
22	**Adopts IRC §163(j) as of 1/1/18**
4	**Adopts IRC §163(j) with interest addback related to intangible income**
8	**Adopts IRC §163(j) and has general interest addback provisions**
6	**Enacted Legislation Decoupling from IRC §163(j) [Note – some of these states did not decouple as of 1/1/2018 but decoupled at a later date and some states may still have an intercompany interest expense adjustment]**
6	**Does not adopt IRC § 163(j) as of 1/1/18**

Source: Council On State Taxation

Interest Expense Limitation – IRC § 163(j)

- **<u>General Overview</u>:** Business interest expense cannot exceed 30% of adjusted taxable income (ATI) exclusive of business interest income and floor plan financing
  - ATI is essentially an EBITA (earnings before interest taxes and amortization) concept through 2021 and then EBIT (earnings before interest and taxes) thereafter.
  - Subject to carryforward.
- **<u>State Tax Issues</u>:**
  - Unlike most states, TCJA coupled the interest expense limitation at the federal level to 100% expensing for cost of capital.
  - How is the limitation computed for state purposes when state and federal filing methodologies differ? **When will state guidance be issued?**
  - 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?

State Conformity to 100% Expensing



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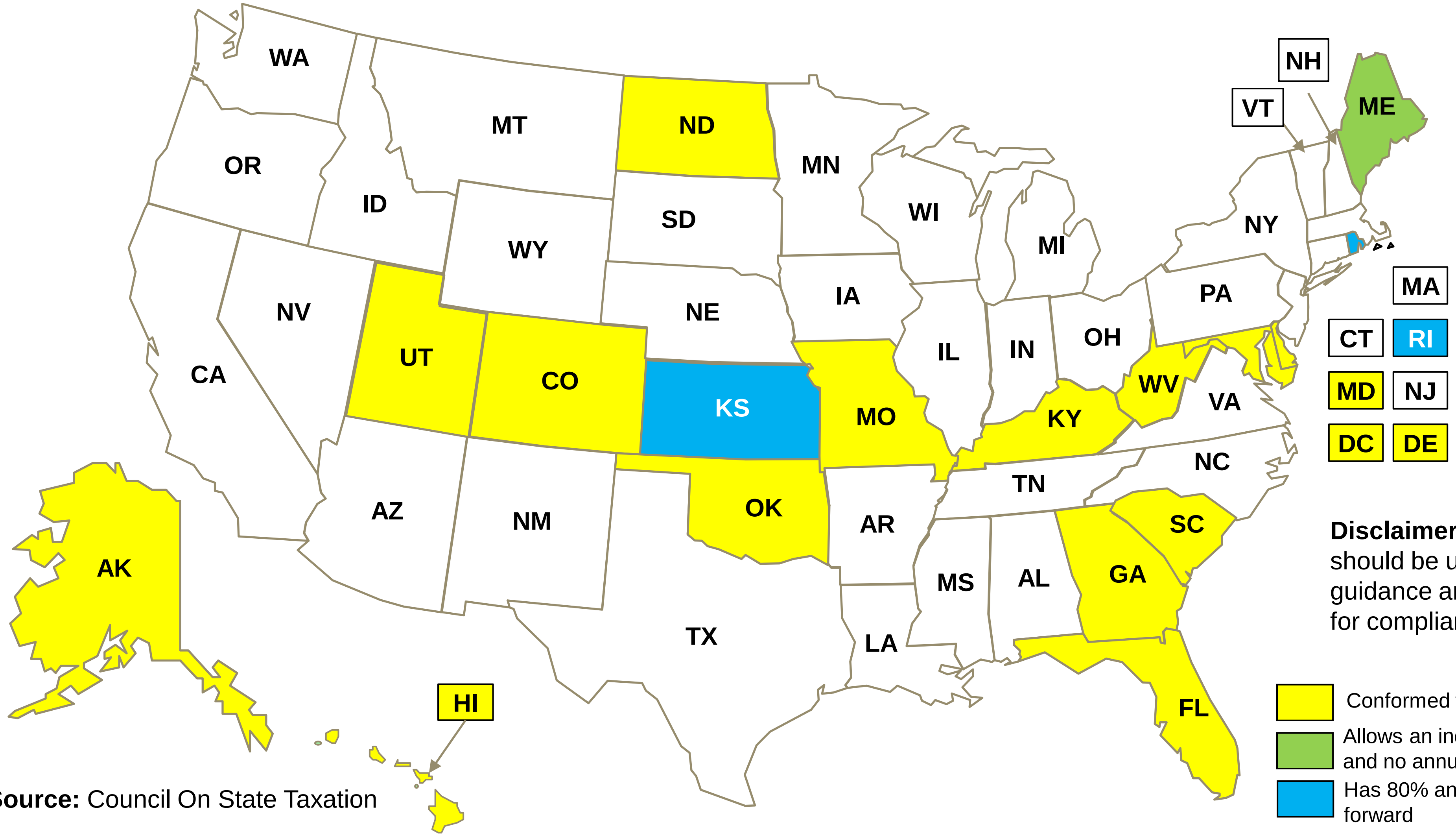
Source: Council On State Taxation

State Conformity with the New TCJA Net Operating Loss (NOL) Provisions



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- Conformed to the federal rule for NOLs
- Allows an indefinite carry forward of NOLs and no annual limitation
- Has 80% annual limitation, but no indefinite carry forward

Source: Council On State Taxation

Other State Tax Issues Related to the TCJA

- **State conformity with the IRC §199A deduction for pass through entities.**
  - Impact limited to a minority of states with PIT tied to federal "taxable income"
  - Almost all states chose NOT to conform, either by inaction or express de-coupling (exceptions: MN, ND, CO, ID and IA (partial))
- **Federal limitation on state and local tax deduction (IRC §164(e)) has engendered strong opposition from many coastal states, but with limited results.**
  - Optional employer payroll tax with employee "credit" for wages subject to payroll tax
  - State-sponsored "charities" to provide essential governmental services
  - State suits against the federal government for intruding on state sovereignty
- **IRC §1031 like-kind exchanges** – amendment deleting tax deferral on qualified exchanges of tangible personal property, e.g., equipment

Other Highlights of the Impact of TCJA on SEATA States

Southeastern States – Summary of De-Coupling Efforts

- GILTI conformity expected to be a non-issue because of either explicit decoupling or separate reporting, which is widely thought to be constitutionally incompatible with GILTI
- Section 965 tax on repatriated income is largely a non-issue in the Southeast except for Tennessee and Louisiana (however, note that Section 965 results for pass-through entities can be very different from the results for corporate entities)
- 30 % Interest Expense Limitation is one to watch as the Southeastern States have not uniformly dealt with this provision
- Georgia – comprehensive conformity law
- North Carolina – decoupled from Opportunity Zone provisions
- South Carolina – conformity bill provides additional dependent exemptions for families with children under 6 years old and prospectively ties tax brackets to inflation to make conformity revenue neutral
- Florida – conformity bill provides automatic corporate income tax rate reduction to offset base-broadening provisions of TCJA, which could lead to corporate income tax refunds

Important Concerns to Note with Southeastern States

- Charitable Deduction Based SALT Cap Workarounds
  - These workarounds are generally designed to allow residents to, *in lieu of paying property taxes*, create charitable funds for a variety of programs where donors can earn a state tax credit in exchange for the donations, effectively bypassing the $10,000 SALT Cap

- Final Treasury Regulations, issued June 11, 2019, put an end to the "Charitable Property Tax Workaround"
  - The regulations limit the amount of the deduction to the difference between the $ amount of the donation and the $ amount of credits received in return
    - The regulations also apply to charitable donations to private school voucher programs offered in 18 states (including SC, GA, AL, LA and FL)
  - The regulations do not address other workarounds passed in New York (payroll tax based workaround known as Employer Compensation Expense Tax or "ECET") and CT, LA, OK, WI and RI (pass-through entity-tax workarounds)

Multistate Tax Commission (MTC) Model Statute on Partnership Audits/RAR Adjustments (approved January 2019)

- Two year joint effort (!) between MTC, COST, TEI, AICPA, IPT, ABA Tax Section SALT Committee and MLPA
- Model statute:
  - Provides uniformity;
  - Incorporates the changes needed for states to conform to the new federal regime in a manner that considers state tax issues and best practices;
  - Establishes more uniform standard for reporting <u>all</u> IRS audit adjustments for all TPs to state tax authorities;
  - Addresses significant changes made to federal audit procedures by the new federal regime that impact state-specific issues such as resident and apportionment; and
  - Addresses many of the concerns of TPs and practitioners as well as state tax authorities.
- As of July 5, 2019, 6 states – California, Georgia, Maine, Oregon, West Virginia and Rhode Island – have passed legislation based in large part on the MTC model statute. Hawaii and Arizona enacted their own unique versions. Bills are pending in Missouri and Ohio and technical corrections bill pending in California.

Questions?

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