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 Corporate Tax Issues Impacting the States
Goals of the Tax Cuts and Jobs Act
Lowering the corporate rate and moving to a territorial system seen as generating economic growth, which is hindered by current uncompetitive tax code.

Drivers are not the same as ‘86 Tax Reform Act, which focused on individual rate reduction.
Improving the International Competitiveness of the 2017 U.S. Income Tax System

Worldwide Taxation
Territorial Taxation
Increase U.S. Reliance on Consumption Tax-Like Principles. Share of Consumption Taxes: 32.4% OECD vs. 17% U.S.

OECD Average Sources of Tax Revenue, 2015
- Consumption Taxes: 32.4%
- Social Insurance Taxes: 25.8%
- Individual Taxes: 24.4%
- Corporate Taxes: 8.9%
- Property Taxes: 5.8%
- Other Taxes: 2.7%

United States’ Sources of Tax Revenue (Federal, State, and Local, 2015)
- Consumption Taxes: 17%
- Social Insurance Taxes: 23.7%
- Individual Taxes: 40.5%
- Corporate Taxes: 8.5%
- Property Taxes: 10.3%

Accelerate U.S. Growth

Source: Bureau of Economic Analysis, January 2017
Transformational Changes in the Tax Cuts and Jobs Act

• Revenue Neutral vs. Deficit Financed
  • The Tax Reform Act of 1986 provided for about $100 billion of (net) PIT cuts financed by about $100 billion of (net) CIT increases over 6 years.
  • 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 effective PIT rate (20% deduction) for pass-through entities.
  • The war on debt: broad new limitations on the interest deductions.
  • The crusade for investment: 100 percent expensing of investments.
  • $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 inadvertent and arbitrary: 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 reduction.
<table>
<thead>
<tr>
<th>Business Tax Provision</th>
<th>% Change in Federal Corporate Tax Base</th>
<th>State Conformity</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-time transition tax on unrepatriated foreign earnings</td>
<td>+ 9 %</td>
<td>Partial conformity (but typically of 25% or less)</td>
</tr>
<tr>
<td>Net interest expense limitation (30% of ATI)</td>
<td>+ 6.4%</td>
<td>Mostly conformity</td>
</tr>
<tr>
<td>Global intangible low-taxed income (GILTI)</td>
<td>+ 5.5% (gross)</td>
<td>Mixed conformity</td>
</tr>
<tr>
<td>Modification of net operating loss deduction</td>
<td>+ 5.3%</td>
<td>States have own provisions</td>
</tr>
<tr>
<td>Base Erosion and Anti-Abuse Tax (BEAT)</td>
<td>+ 4.0%</td>
<td>Non-conformity</td>
</tr>
<tr>
<td>Amortization of research and experimental expenditures</td>
<td>+ 2.9%</td>
<td>Conformity</td>
</tr>
<tr>
<td>Repeal of domestic production activities deduction</td>
<td>+ 1.9%</td>
<td>Partial conformity</td>
</tr>
<tr>
<td>Foreign derived intangible income (FDII) deduction</td>
<td>- 1.7%</td>
<td>Mixed conformity</td>
</tr>
<tr>
<td>Expensing provided under Section 168(k) bonus depreciation</td>
<td>- 1.8%</td>
<td>Limited conformity</td>
</tr>
<tr>
<td>Global intangible low-taxed income (GILTI) deduction</td>
<td>- 2.6%</td>
<td>Mixed conformity (but §250 issue)</td>
</tr>
<tr>
<td>100% foreign DRD</td>
<td>- 5.9%</td>
<td>States have own provisions</td>
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State Tax Budget Considerations: Good News and Bad News

- 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)
  - $5 to $8 billion estimated annual state corporate income tax revenue increase from state conformity with the TCJA (COST/EY study)

- The federal limitation on SALT deduction is a significant concern for many states, particularly the coastal states.

- 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
Piecing Together The State Impacts Of Federal Tax Reform

The various forces within the state tax policy environment will continue to react to TCJA provisions, including:

• GILTI and FDII
• Immediate expensing and interest expense limitations
• Section 172 NOL deduction
• Section 118 contributions to the capital of a corporation
• Sections 1400Z-1 and 1400Z-2 Opportunity Zone program
• Other international provisions
• Treasury Regulations on such provisions
Key International Tax Provisions Impacting the States
Key International Provisions

<table>
<thead>
<tr>
<th>Dividend Exemption</th>
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<tbody>
<tr>
<td>100% deduction for foreign-sourced portion of dividend received by domestic corporation from specified 10%-owned foreign corporations. (Deduction not available for capital gains or directly earned foreign income)</td>
</tr>
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<thead>
<tr>
<th>Transition tax</th>
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<tbody>
<tr>
<td>► One-time transition tax on post-1986 earnings of 10% owned foreign subsidiaries accumulated in periods of 10% US corporate shareholder ownership.</td>
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<tr>
<td>► 15.5% rate on cash and cash equivalents, and 8% rate on the remainder.</td>
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<thead>
<tr>
<th>Global Intangible Low-Taxed Income (GILTI)</th>
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<tr>
<td>► Mandatory annual inclusion of “global intangible low-taxed income” (GILTI) determined on an aggregate basis for all controlled foreign corporations owned by the same US shareholder.</td>
</tr>
<tr>
<td>► Partial credits for foreign taxes properly attributable to the GILTI amount.</td>
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<tr>
<th>Base Erosion Minimum Tax (BEAT)</th>
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<tr>
<td>► If certain thresholds are met, a BEAT is levied on TI without regard to certain deductible amounts paid or accrued to foreign related persons (FRPs); depreciation or amortization on property purchased from FRPs; and certain reinsurance payments to FRPs.</td>
</tr>
<tr>
<td>► Generally 10% rate for tax years beginning before 12/31/25, and 12.5% thereafter</td>
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<tr>
<th>Foreign-derived intangible income (FDII)</th>
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<td>► Domestic corporations allowed a deduction against foreign-derived intangible income, or “FDII”, (37.5% deduction initially, reduced to 21.875% for tax years beginning after 12/31/25) and mandatory GILTI inclusion (50% deduction initially, reduced to 37.5% for tax years beginning after 12/31/25)</td>
</tr>
<tr>
<td>► Essentially a “Patent Box”</td>
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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 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.
One-Time Repatriation (Transition) Tax Conformity for 2017 Tax Year

Adopts 965, with 95% or more DRD or Subpart F modification

Adopts 965, without 100% DRD or Subpart F modification

Does not adopt 965

No General Corporate Income Tax

Adopts 965, with 95% or more DRD or Subpart F modification

Based on 100% ownership of CFC

15
Adopts 965, without 100% DRD or Subpart F modification

11
Does not adopt 965

5
No General Corporate Income Tax

20
Adopts 965, with 95% or more DRD or Subpart F modification

* (#2) adopts 965 for 2017, not 2018
** (#) dividends are allocable; no DRD
*** (#1) adopts 965 for 2018, not 2017
# (1) provides a 100% DRD for dividends paid after 7/1/18
^ (#4) expense disallowance provisions attributable to DRDs or exempt income

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Transition Tax State Issues

- Will states adopt the §965(c) tax rate reduction?
- Apportionment and factor representation issues.
  - 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 filing method, 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.
- If all mandatory repatriated income is excluded, will the state disallow expenses associated with the income?
- Will the states allow taxpayers 30 additional days to file 2017 returns or provide a penalty waiver?
Base Erosion and Anti-abuse Tax (BEAT)

• The BEAT is an alternative minimum tax that applies to certain corporations with:
  • Average annual gross receipts of at least $500 million for three-year period ending with preceding taxable year.
  • A base erosion percentage of at least 3% (or 2% in the case of a bank or registered securities dealer). Base erosion percentage is generally the aggregate amount of base erosion tax benefits divided by aggregate amount of all allowable deductions.
• BEAT is the greater of:
  • Regular tax versus
  • 10% of modified taxable income, which reflects regular taxable income PLUS
    • Related party deductions, including for services (but not including lower-margin, back office services)
    • Associated FTCs
    • Miscellaneous credits
• The BEAT is phased in from 5% in 2018, to 10% in 2019, to 12.5% in 2016
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% (increased to 16.406% in 2026).
Is the Impact of GILTI the Same for State Tax Purposes as it is for Federal 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 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 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.
Current Status of State Conformity to GILTI

- **Decoupled from GILTI (or excludes 95%) by legislation or administrative action**
- **Potentially coupled to GILTI, but inclusion is likely constitutionally prohibited in separate reporting states**
- **Have not addressed IRC conformity and/or GILTI coupling specifically**
- **Coupled or potentially coupled to GILTI**

*Generally, GILTI is not specifically referenced in state conformity statutes so there remains the possibility that some of these states will decouple from some or all of GILTI by administrative guidance (e.g., Kentucky, Connecticut) or future clarifying legislation.*

**ND excludes 70% of GILTI; MT excludes 80%.

Source: Council On State Taxation
**Kraft precedent: Constitutional Limitations on the State Taxation of Foreign Commerce**

- **Separate Reporting States:** 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.
  - Important to recognize that the governing principle was not discrimination against *dividends per se*, but against *foreign commerce*. Thus, under the *Kraft* precedent, the state taxation of GILTI would be similarly prohibited in separate reporting states.

- **Combined Reporting States:** The fact pattern is different for taxing foreign subsidiaries dividends (or GILTI) in combined reporting states because these states include the income and apportionment factors of domestic subsidiaries in the calculation of taxable income.
  - Nonetheless, the taxation of GILTI in combined reporting states likely violates Commerce Clause limitations unless foreign “factor representation” is allowed. Otherwise, the foreign income is discriminated against because its income-generating factors are not taken into account.
Factor Representation: GILTI

• If combined reporting states choose to tax GILTI, but concede it is necessary to offer factor representation, what might the apportionment formula look like?

• Basic principles to follow:
  • Utilize the factors of all of the CFC’s and not just the first CFC in a multi-tiered foreign chain.
  • Include the gross sales of the CFCs in the denominator of the sales factor, and not just the net GILTI amount.
    • Adjust the gross sales as necessary to reflect only the portion of CFC gross sales that are related to GILTI.
  • Combine the foreign gross sales (as adjusted) and other foreign factors (as appropriate) with the domestic sales and other domestic factors and apply to the income of the waters’ edge combined reporting group (including GILTI).
  • Precedent for this approach can be found in the Multistate Tax Commission’s Model Statute for Combined Reporting for factor representation relating to certain categories of foreign source income such as subpart F income or income from so-called 80/20 companies.
Foreign Derived Intangible Income (FDII): IRC §250

- **General Overview:** 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. on whether a state’s starting point for calculation of state taxable income is Form 1120 line 28 or line 30.

- **State Tax Issues:**
  - 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.
Which states decoupled from the TCJA’s **Foreign Derived Intangible Income (FDII)** provisions?

Notes: Michigan: the Michigan Department of Revenue issued guidance effectively disallowing the FDII deduction; we believe this guidance is wrong. Oklahoma: the Oklahoma Tax Commission’s regulations provide that special deductions are not included in the computation of state taxable income. Pennsylvania: the Department of Revenue’s regulations provide that special deductions are not included in the computation of state taxable income.

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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**:
  - Unlike most states, TCJA coupled the interest expense limitation to 100% expensing for cost of capital.
  - How is the limitation computed for state purposes when state and federal filing methodologies differ?
  - External vs. internal debt (especially for sep. 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?
  - States that have decoupled to date from 163(j): Connecticut, Georgia, Indiana, Mississippi, South Carolina, Tennessee (2020), Wisconsin.
State Conformity to 30% Interest Expense Limitation

No General Corporate Income Tax

Adopts 163(j) as of 1/1/18

Adopts 163(j) with interest addback related to intangible income

Adopts 163(j) and has general interest addback provisions

Enacted Legislation Decoupling from 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]

For 2018 tax year – IRC adopted as of 1/1/2017 effectively decoupling from 163(j)

Does not adopt 163(j) as of 1/1/18

* (#1) adopts 163(j) in 2019

** (#1) adopts 163(j) in 2018 and 2019, then decouples. State has interest addback
**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%. It is likely that states with 80%+ of the population base will decouple.
  - Straight coupling to federal vs. MACRS vs. different approaches
  - Tracking different methods in different states
Tax impacts of debt and acquisition of capital assets

Recall that, from a federal policy standpoint, the Section 163(j) business interest deduction limitation and full expensing of qualified property under Section 168(k) go hand-in-hand. However, in the state tax base an imbalance may exist.
State Conformity to 100% Expensing (as of Oct. 8, 2018)

State does not adopt revised 168(k)

Adopts revised 168(k)
Other State Corporate and Personal Income Tax Issues

- **Net Operating Losses**
  - Most states have their own provisions, but there is some conformity with the new federal provisions limiting NOLs to 80 percent and allowing an unlimited carryforward.

- **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
  - State suits against the federal government for intruding on state sovereignty
State Conformity with the New TCJA Net Operating Loss (NOL) Provisions

- **Conformed to the federal rule for NOLs**: AL, AK, AZ, CA, CO, DC, FL, GA, HI, ID, ME, MD, MA, MI, MN, MO, MT, NE, NH, NJ, NM, NV, NY, OH, OK, OR, PA, HI, IA, KS, KY, LA, ME, MI, MN, MO, MS, MT, NE, NV, NY, NM, OH, OK, OR, PA, RI, SC, SD, TN, TX, UT, VA, WA, WI, WY

- **Allows an indefinite carry forward of NOLs and no annual limitation**: ME, VT

- **Has 80% annual limitation, but no indefinite carry forward**: DE, MD, NJ, NY, PA, VA, WY

*Note: The map shows states that conform to the new TCJA NOL provisions.*

*Source: www.csg.org | CSG 2018 National Conference | Dec. 6-8*
Top individual provisions:

- Seven brackets: 10%, 15%, 22%, 25%, 32%, 35%, 37%
- Standard deduction set at $24k for joint returns, $12k for single filers; personal exemptions repealed
- Net capital gains and qualified dividends retain current law; subject to 3.8% net investment income tax
- Individual alternative minimum tax (AMT) retained; exemption amount increased; phase-out of exemption increased
- Estate tax exclusion increased to $10m (indexed for inflation)
- Child tax credit increased to $2k, $1,400 refundable; phase-out increased to $200k (single) and $400k (MFJ)
- Principal cap on deductible home mortgage interest for new mortgages (after 12/15/17) reduced from $1m to $750k; deduction retained for second homes but no longer available for home equity lines
- Itemized deductions subject to 2% floor repealed
- Medical expense deduction would apply to expenses that exceed 7.5% of adjusted gross income (AGI) in 2017 and 2018 and expenses that exceed 10% of AGI thereafter
- 50% AGI limitation for charitable contributions increased to 60% for gifts of cash to specified organizations
- State and local deduction available for $10k of property and income (or sales) taxes
- ACA “shared responsibility payment” reduced to $0