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Tax Reform Phase II – State Responses to the 2017 Tax Act

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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 Issues 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 $100 billion of PIT cuts financed by about $100 billion of 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 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 Conformity

States rely heavily on the federal tax code. States do this for two reasons:

- Ease for tax filers
- Reduces administrative burden

This presents an opportunity for states to reform their tax codes in response, following their actions in 1986.
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 presents an opportunity for states to reform their tax codes in response, following their actions in 1986.

- Approximately half of states have taken a conformity action so far this year.
State Partial Conformity with the TCJA

Corporate Income Tax Conformity

Note: States conform to the federal tax code on either a static or rolling basis. Static conformity means conforming to the Internal Revenue Code (IRC) as of a specific date, such as January 1, 2016. Rolling conformity means adopting IRC changes as they occur. *Gross receipts taxes are not comparable to corporate income taxes.

Michigan taxpayers have the choice of rolling conformity or the tax code as of January 1, 2012. Maryland has rolling conformity unless the Comptroller finds a revenue impact of greater than $5 million.

Source: Bloomberg BNA

Rolling Conformity
Static Conformity
No Conformity (State Calculation)
State Levies Gross Receipts Tax*
No Corporate Income Tax
## Top Increases and Decreases in Federal Corporate Tax Base with TCJA and Potential State Conformity

<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 (but §250 issue)</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>
</tr>
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State Budget Considerations

- Anticipated state tax revenue increases from the Wayfair decision, conformity with the TCJA, and a sustained economic recovery
  - Half of states have reported revenue changes due to conformity. All but two saw an increase.
  - $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

- Some states have structural budget gaps arising from pension liabilities, infrastructure needs and rising health care costs
Key International Tax Provisions Impacting the States
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 by legislation or administrative action (in some states, subject to DRD limitations)**
- **Potentially coupled to GILTI, but inclusion is constitutionally prohibited in separate reporting states**
- **Coupled or potentially coupled to GILTI**
- **Have not addressed I.R.C. conformity and/or GILTI coupling specifically**

*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.*

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 factor relief 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.

- **Don’t reduce the foreign gross sales to account for the Section 250 deduction** (because this is intended federally as a rate reduction and not a tax base adjustment).

- 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 factor representation approach can be found in:

- The IRC model for computing allowable foreign tax credits relating to GILTI.
- The “Detroit formula” used by some states and localities for factor relief relating to the taxation of foreign dividends.
- The approach taken by the Multistate Tax Commission 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. In each instance of foreign income inclusion, the MTC model statute includes in the taxpayer’s apportionment calculation “the apportionment factors related to that income.”

A similar approach may be required for factor representation for the transition tax on repatriated earnings.
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.
Potential State Taxation of Accumulated Foreign Earnings

This analysis assumes each state will update to the 2018 IRC consistent with the provisions the state conformed to prior to the enactment of the TCJA. This map is intended for general information purposes only and should not be relied upon for tax advice.
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?
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).

**State Tax Issues:**

- Deduction for FDII under IRC § 250 is likely a “special deduction,” thus state conformity may be dependent on a state’s starting point for calculation of taxable income (e.g. Form 1120, line 28 or line 30).
- The impact of FDII may be affected by a taxpayer’s state income tax filing method.
- Selective decoupling – FDII, as enacted, is designed to work with GILTI.
- There will be novel issues associated with this new “patent-box”-like provision.
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?
    - Conformity to consolidated return regulations
  - 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.
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

- **Net Operating Loss**
  - Generally, states have their own NOL provisions, but issues in some states.