Federal Tax Reform & the States

The Big Picture

Status Update in the States

Introductions | Panelists

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Council On
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State Impact | Tax Cuts and Jobs Act

- NCSL Resources on federal tax reform (FTR)
  - [General resources on FTR and the states]
  - [Past Task Force presentations on FTR]

Estimating Revenue Changes

State	Overview of Revenue Estimates	Revenue Reports
Arizona*	Increase in revenue of $236 million in fiscal year 2019.	See Story
Colorado	Increase in revenue of $196.5 million in fiscal year 2018-2019.	Download
Georgia*	Increase in revenue of $5.2 billion over five years.	See Story
Idaho	Increase in revenue of $97.4 million in fiscal year 2019.	Download
Indiana	Increase in revenue of $129 million in fiscal year 2019.	Download
Iowa	Increase in revenue of $188.3 million in fiscal year 2019.	Download
Louisiana*	Increase in revenue of $226 million in fiscal year 2019.	See Story
Maine	Increase in revenue of $312 million in fiscal year 2019.	Download
Maryland	Increase in revenue of $361 million in fiscal year 2019.	Download
Massachusetts**	Increase in revenue of $65 million in fiscal year 2019.	See Story
Michigan	Increase in revenue of $1.7 billion in fiscal year 2019.	Download
Minnesota	Increase in revenue of $416 million in fiscal year 2019.	Download

Source: Tax Foundation, "State Tax Conformity: Revenue Effects," https://taxfoundation.org/state-tax-conformity-revenue-effects/.

Estimating Revenue Changes

Montana*	Decrease in revenue of of $46 million in fiscal year 2018. Montana's revenue projections have been disputed.	See Story
Nebraska*	Increase in revenue of $220 million this year.	See Story
New York	Increase in revenue of $1.1 billion in fiscal year 2019.	Download
North Dakota*	Decrease in revenue of $28.9 million in the 2019-21 biennium. Excluding the pass-through provision would result in a revenue increase.	See Story
Oregon	Decrease in revenue of $40 million in fiscal year 2019. Excluding the pass-through provision would result in an increase in revenue of $151 million.	Download
Pennsylvania	Increase in revenue of $340 million in fiscal year 2018-2019.	Download
South Carolina	Increase in revenue of $205 million in fiscal year 2018-2019.	Download
Vermont	Increase in revenue of $30 million in fiscal year 2019.	Download
Washington	Increase in revenue of $85 million in fiscal year 2018.	Download
District of Columbia	Increase in revenue of $51.9 million in fiscal year 2019.	Download

*States have not released official reports, but revenue numbers have been reported in news articles.

**This estimate only includes the impact of the new international tax provisions.

Source: Tax Foundation, "State Tax Conformity: Revenue Effects," https://taxfoundation.org/state-tax-conformity-revenue-effects/.

Estimating Revenue Changes

- New EY/COST study estimates impacts of TCJA on state corporate tax bases.
- Examines impact of all states updating CIT codes to match the TCJA, but remaining coupled to specific provisions as they have in the past.
- Estimated change in corporate tax base from TCJA is an increase of 12% over the first 10 years (2018-2027), with significant variation among tstats.

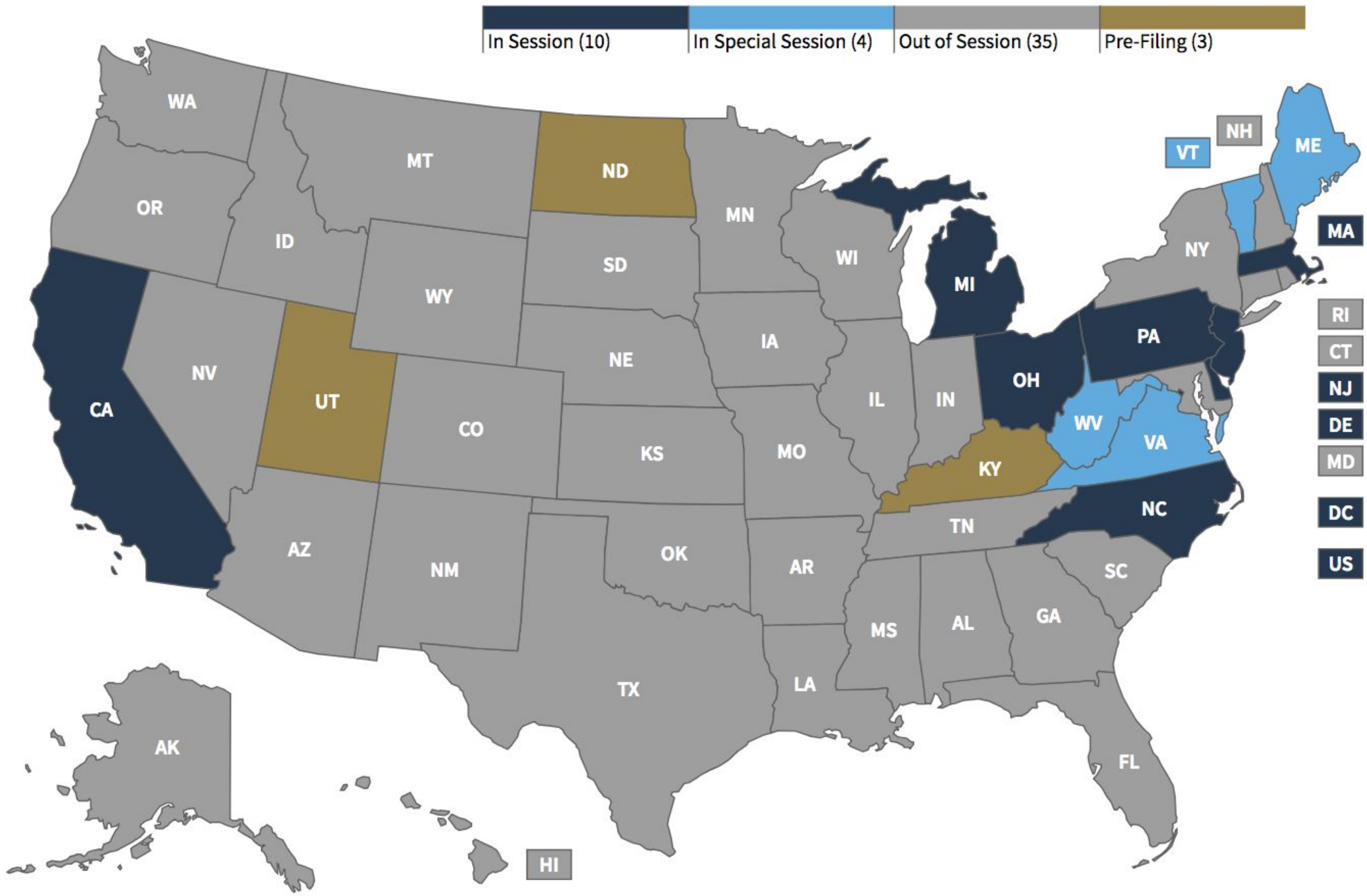
Estimating Revenue Changes

State	% increase in state corporate tax base	State	% increase in state corporate tax base
Alabama	11%	Nebraska	11%
Alaska*	12%	Nevada	n/a
Arizona	14%	New Hampshire*	13%
Arkansas	12%	New Jersey*	12%
California**	12%	New Mexico*	11%
Colorado	12%	New York*	12%
Connecticut*	12%	North Carolina	12%
Delaware	10%	North Dakota	10%
Florida	13%	Ohio	n/a
Georgia	12%	Oklahoma	13%
Hawaii*	13%	Oregon*	10%
Idaho	9%	Pennsylvania*	14%
Illinois	9%	Rhode Island*	11%
Indiana*	12%	South Carolina	12%
Iowa	13%	South Dakota	n/a
Kansas	11%	Tennessee*	12%
Kentucky*	12%	Texas	n/a
Louisiana	12%	Utah*	12%
Maine	12%	Vermont	14%
Maryland*	12%	Virginia	13%
Massachusetts*	12%	Washington	n/a
Michigan	9%	West Virginia	9%
Minnesota*	12%	Wisconsin*	9%
Mississippi*	4%	Wyoming	n/a
Missouri	11%	District of Columbia	12%
Montana*	9%	Overall change	12%

Source: Council On State Taxation, "The Impact of Federal Tax Reform on State Corporate Income Taxes," https://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/cost-federal-tax-reform-3-1-2018-cost-v2.pdf.

What's Next? | Expected Action Timetable

- **State Legislative Action**
  - Most states are now out of session. In those where there are still issues to resolve, action likely during the 2019 legislative sessions.
  - Some states are still in general session; some holding special sessions currently; others could hold them in coming months.
- **State Regulatory Action** - ongoing/could come at any time.
- **IRS Guidance**
  - Key guidance on repatriation transition tax expected in July or August.
  - Other guidance on international provisions (GILTI, FDII, BEAT) and interest expense limitation provision expected by late November.



Source: MultiState Associates. Data as of June 29, 2018.

What States Have Done So Far:
Personal Income Tax

Personal Income Tax | Key Provisions in TCJA

- **Base Broadening Provisions**
  - Personal and dependent exemptions eliminated [151]
  - SALT deduction limit [164(b)(6)]
  - Misc. itemized deductions suspended [67(g)]
- **Base Narrowing Provisions**
  - Increased standard deduction [63(c)(7)]
  - Pass-through deduction [199A]
  - 529 plan qualified higher education expenses include K-12 tuition payments [529(c)(7)]

Elimination of Exemptions | Early State Activity

- **Idaho** conformed to the suspension of exemptions, but reduced income tax rates and increased the nonrefundable child tax credit.
- **Michigan** preserved exemptions for Michigan taxpayers.
- **Maryland** preserved exemptions while enhancing targeted benefits for 529 contributions, payors of student loans, retired correctional officers and retired members of the Armed Forces and teachers. Maryland also expanded EITC to include individuals without dependents.
- **Iowa** generally conformed to the TCJA and will switch from static conformity to rolling conformity beginning in 2020. If revenue targets are met, Iowa will reduce the rates, as well as the number of income tax brackets and will switch from federal AGI to federal taxable income as a starting point in 2023.

State Workarounds | SALT Deduction Limit

- Voluntary payroll tax coupled with employee PIT credit (**New York**)
- Charitable contribution to state fund in lieu of income/real property tax (**California**, **New York**, **New Jersey**, **Connecticut**)
- Entity level tax on pass-through entities (**Connecticut**)

State Workarounds | Voluntary Payroll Tax

- **Workaround**: voluntary payroll tax coupled with employee PIT credit
- **Mechanics**
  - Employer pays additional payroll tax on income over a threshold
  - Employee gets 1:1 credit against personal income tax liability
- **Issues**: will employer voluntarily pay additional tax in exchange for a partial tax benefit?
  - Employer can deduct the payroll tax, but the deduction is worth less than the payroll tax payment.
  - The employee can't agree to take a pay cut in exchange for the employer paying this payroll tax.

State Workarounds | "Voluntary" Contributions

- **Workaround**: "voluntary" contributions to state funds
- **Mechanics**
  - Taxpayer makes voluntary contribution to state fund
  - Taxpayer gets 85% credit against personal income tax liability
  - Taxpayer deducts 100% of voluntary contribution on fed return
- **Issues**
  - Generally charitable deduction is not allowed when donor receives something of value. Is tax benefit offered by a state in exchange for a donation something of value?
  - Internal Revenue Service (IRS) Chief Counsel Advice from 2011
  - How is this different from existing credits in AR, AZ and AL?
  - IRS guidance coming soon. Will likely deny + litigation will follow.

State Workarounds | Entity-Level Tax

- **Workaround**: entity level tax on partnerships and S-corps
- **Mechanics**
  - Owners of S-corps and partnerships will be required to calculate and pay tax with entity tax return.
  - Owners will receive a credit against individual income tax for tax paid by the entity.
  - This allows tax to be deducted as a business expense on federal return; not subject to SALT limit.

Other Issues | Pass-Through Deduction Conformity

- IRC 199A allows sole props, partners, and S-corp shareholders a deduction of up to 20% of their net business income.
- Limits apply based on taxable income, business type, wages paid by the business, and property owned by the business.
- States using federal taxable income (FTI) as a starting point need to decide whether to conform to IRC 199A.
- Selected states:
  - **Oregon** will not conform. Projected to save $1.3B over 6 years.
  - **Iowa** will switch to FTI as starting point in 2019 and will require a partial add-back of 199A deduction.
  - **Wisconsin** and **Kentucky** start with AGI, but specifically decoupled from 199A.

Other Issues | 529 Plan Distributions for K–12 Tuition

Conformity with IRC 529(c)(7) – higher education expense includes K-12 tuition.

- Several states have already conformed.
- Montana's DOR announced that K-12 tuition is not a qualified expense under Montana's current law. Thus, 529 plan distributions can't be used for K-12 tuition by MT taxpayers without facing tax and penalties on the MT return.
- Difficult to project cost of conformity.
- Nonconformity creates confusion for taxpayers.

What States Have Done So Far:
Business Taxes

Resources for State Guidance | STAR Partnership

- **State Taxes After Reform (STAR) Partnership**
  - Formed to help the business community navigate the state legislative, executive, and regulatory reaction to federal tax reform.
  - Key issues: repatriation transition provisions, GILTI, interest limitation deduction, contributions to capital, FDIC fees, FDII, expensing, BEAT.

STATE TAXES AFTER REFORM
PARTNERSHIP

General Resources

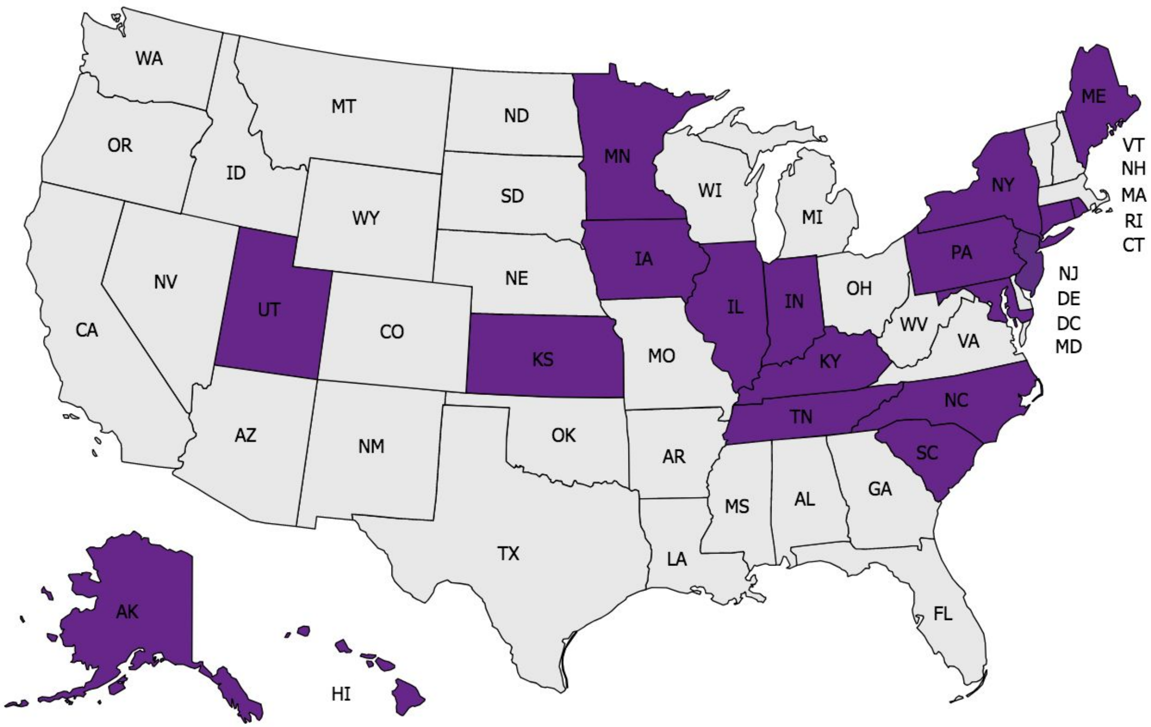
- **Advocacy Packet**. Click here to download our advocacy packet, which explains the goals of the STAR Partnership and provides guidance for states in each major issue area. Most importantly, it explains our key point: that states blindly conforming to the IRC is not the right answer, and for businesses, conformity without modification is a significant tax increase.

- **Guidelines for Rolling Conformity States**. Click here to download our guidelines for rolling conformity states. Lawmakers in states which automatically conform to the most recent version of the Internal Revenue Code must take special attention. Rolling conformity creates an accidental tax policy change—a large business tax increase—with no legislative input. Inaction during the 2018 legislative sessions may negatively impact investment and job creation.

- **FAQs.** This document answers frequently asked questions about the TCJA's impact on states and why states should avoid conforming to certain provisions of the IRC.

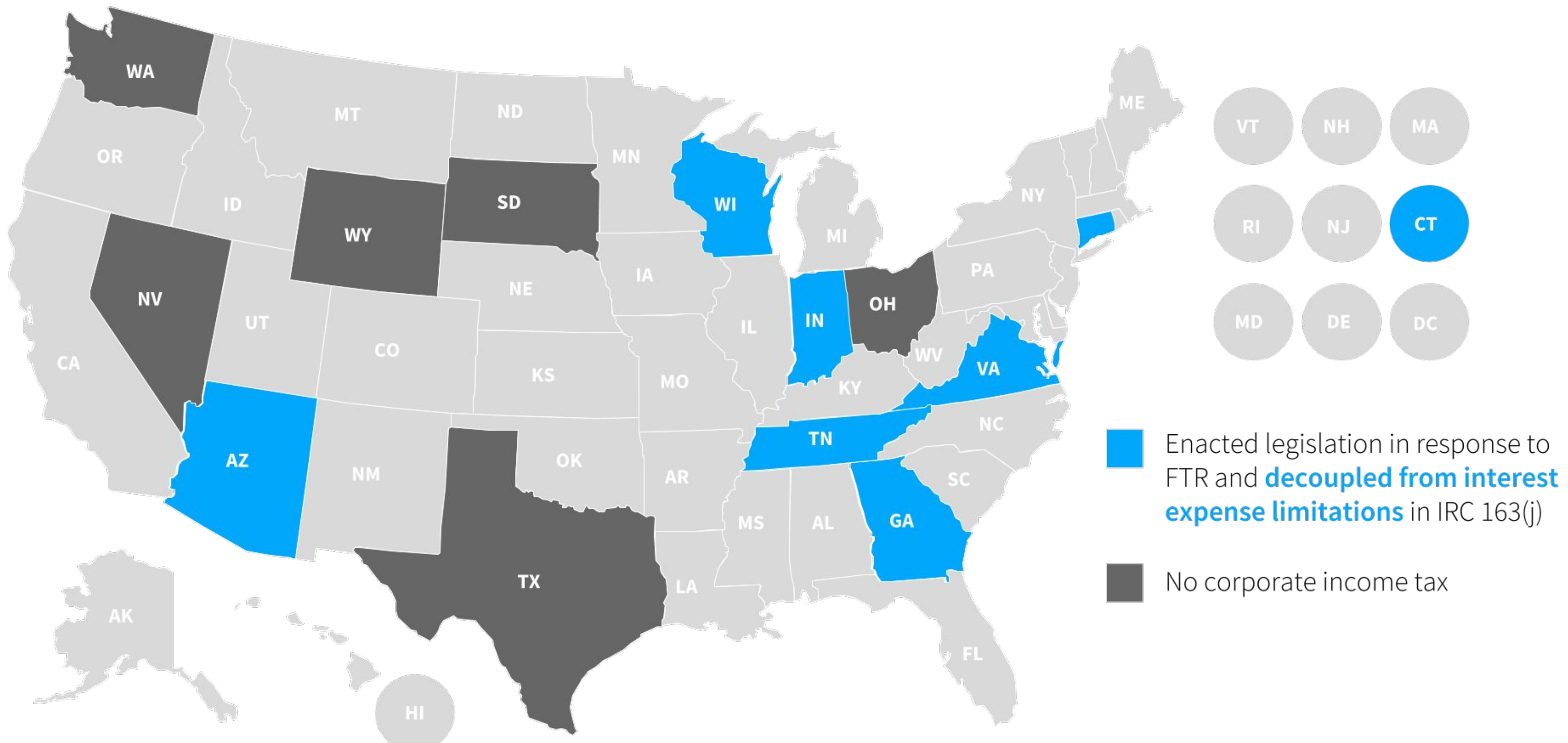
STATE TAXES AFTER REFORM
PARTNERSHIP

State-Specific Resources



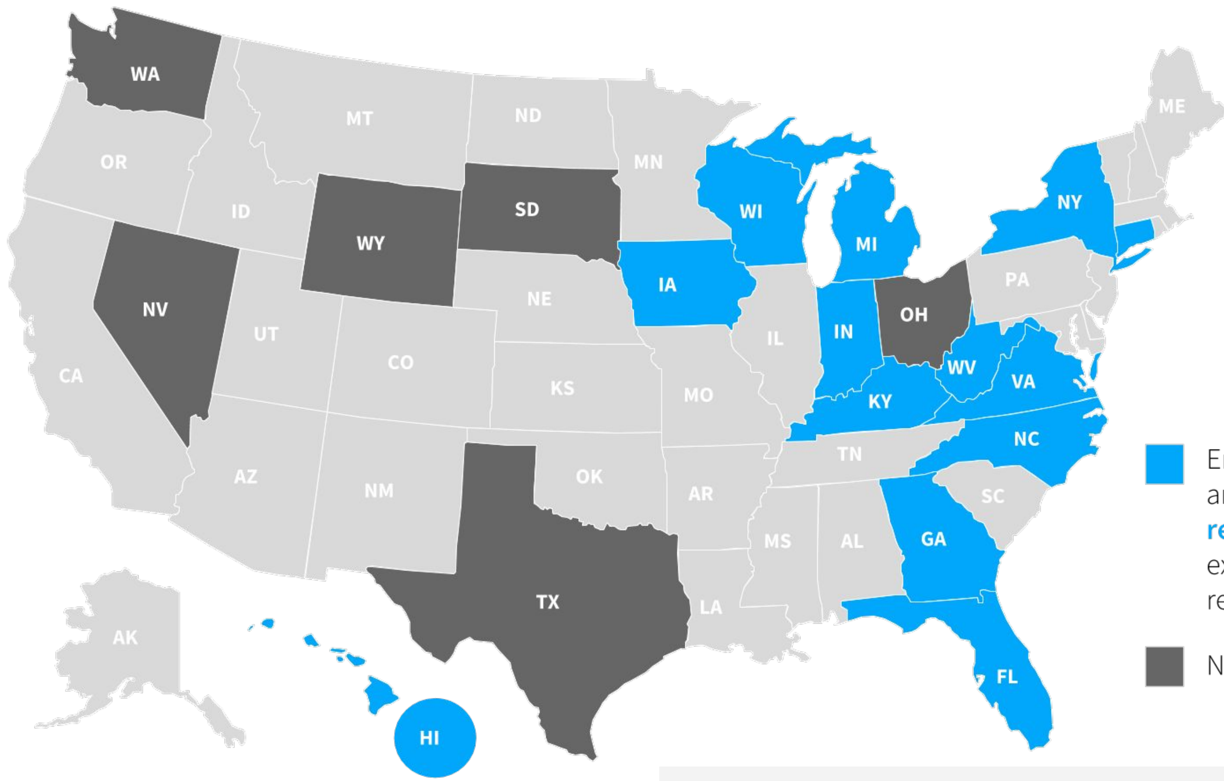
star-partners.org

State Non-Conformity | Interest Expense Limitations



Source: STAR Partnership. Data as of June 15, 2018.

State Non-Conformity | Repatriation Transition Tax



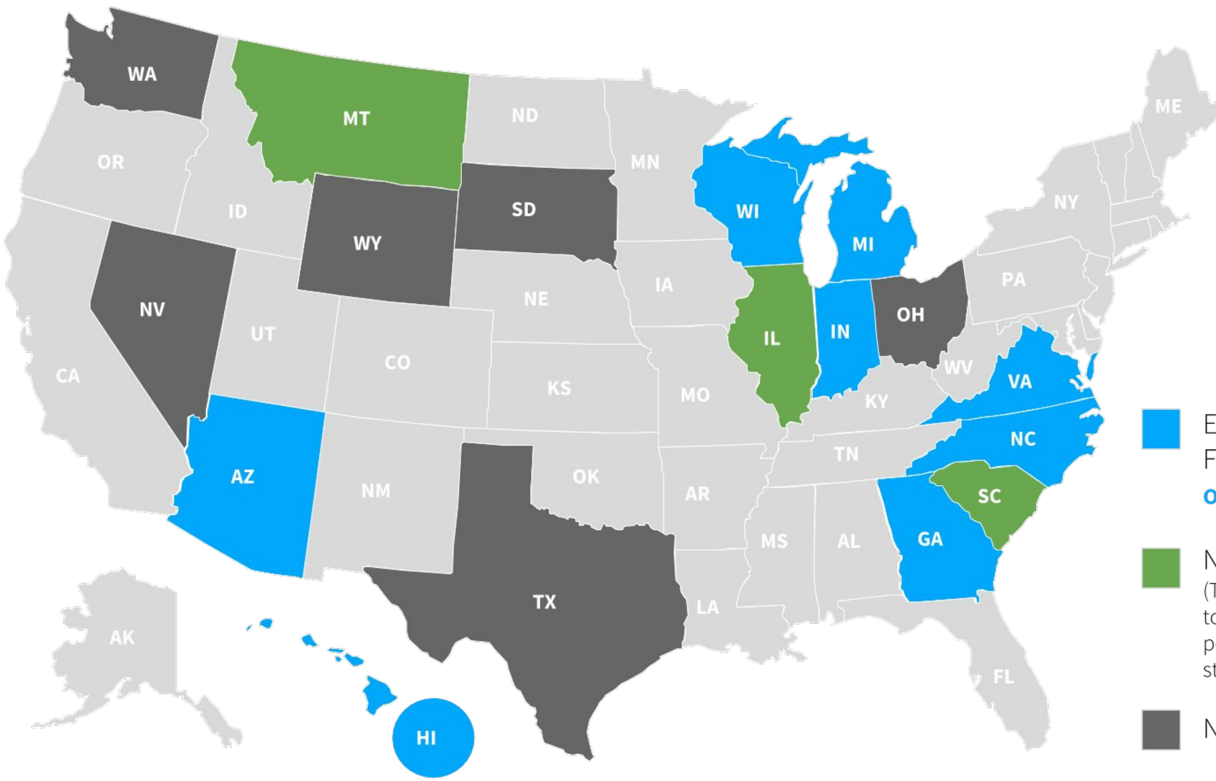
Enacted legislation in response to FTR and **decoupled from deemed repatriation provisions** in IRC 965 or excluded foreign earnings deemed repatriated from state base

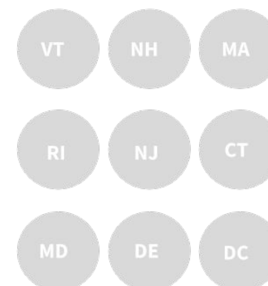
No corporate income tax

Source: STAR Partnership. Data as of June 15, 2018.

Note: this slide doesn't show all the states that decouple, it shows the states that enacted legislation (or will soon). For the full list of states, please come chat with us after. There are other states not shown on this map that don't pick up the repatriation transition tax due to preexisting law.

State Non-Conformity | GILTI





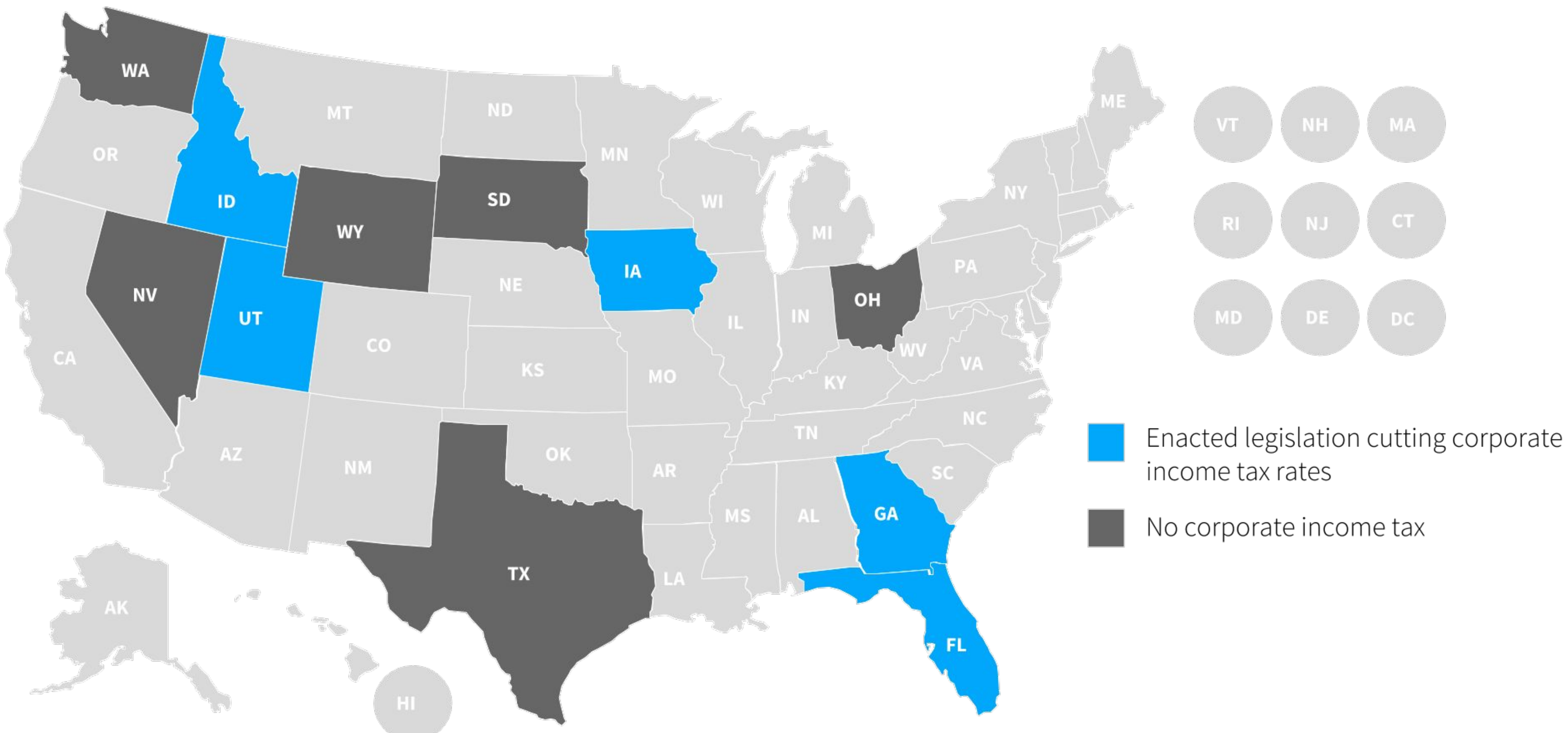
Enacted legislation in response to FTR and **decoupled from IRC 951A or excluded GILTI** from state base

No conformity due to preexisting law
(This category may not be all-inclusive and is meant to highlight a handful of states; full analysis pending. Some states also may decouple based on static conformity to the IRC.)

No corporate income tax

Source: STAR Partnership; Council On State Taxation. Data as of June 15, 2018.

State Corporate Income Tax | Rate Reductions



Source: Council On State Taxation. Data as of June 15, 2018.

Issues Arising from State Tax Conformity with TCJA's International Provisions

Pre–TCJA State Taxation of Foreign Source Income

The Water's Edge

- States generally did not follow federal "worldwide income" tax regime
- Both separate entity and combined return filing states generally limited taxation to the "water's edge"
- Exceptions in some states:
  - Non-mandatory worldwide reporting
  - 80-20 companies
  - Tax haven provisions
  - Related party add back statutes
  - Partial taxation of foreign dividends

Pre–TCJA State Taxation of Foreign Source Income

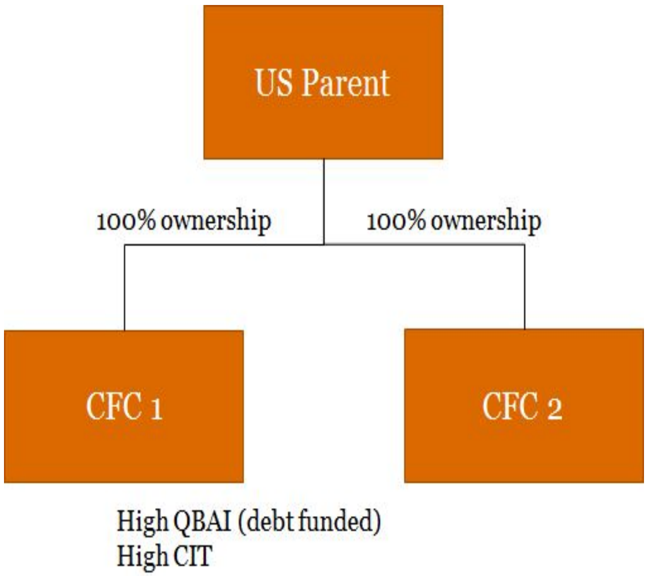
Beyond the Water's Edge

- Transition Tax on Foreign Deferred Income
- Global Intangible Low-Taxed Income (GILTI)
- Foreign Derived Intangible Income (FDII)
- Base Erosion Anti-Avoidance Tax (BEAT)
  - (not currently adopted by any states)
- Amortization of Research and Experimentation
- Other Related Provisions:
  - 40 percent corporate income tax reduction (35% to 21%)
  - 100 percent Foreign DRD (Territorial Taxation)

State Partial Conformity with the TCJA

- TCJA resulted in a federal tax cut for corporations of about 10%, but according to the COST/ EY study it will result in an average state corporate tax base increase of about 12% (based on 2018 update and pre-FTR linkage to IRC).
- This outcome is entirely inadvertent: if states conform mechanically to TCJA, they link to federal corporate base-broadeners but not rate cuts.
- As a general principle, conformity with federal laws can facilitate taxpayer compliance and reduce taxpayer burdens.
- **HOWEVER, this is not conformity**, **but inadvertent and arbitrary partial conformity.** Conformity would result only if states that conform to the revenue raising provisions of federal tax reform also enact off-setting state corporate tax cuts.

GILTI | How Does It Work?



	GILTI			
	Item	CFC1	CFC2	US Parent
1	Tested Income[1]	$105	$95	$200
2	Tested Loss	$0	$0	$0
3	Net CFC Tested Income			$200
4	Tested Foreign Income Taxes	$25	$5.50	$31
	Foreign effective tax rate on tested income	*19.2%*	*5.5%*	*13.2%*
5	Qualified Business Asset Investment[2]	$1,500	$200	$1,700
6	Net deemed tangible income (10% L5)			$170
7	Interest expense that reduced tested income	$50	$0	$50
8	Excess of L6 over L7			$120
9	GILTI (Excess of L3 over L8)			$80
10	Inclusion percentage (L9/L3)			40%
11	Deemed Paid Credit before 20% haircut (L10*L4)			$12.20
12	Deemed Paid Credit after 20% haircut (80%*L11)			$9.76
13	Grossed up GILTI (L9 + L11)			$92.20
14	50% Deduction (50% * L13)			$46.10
15	Taxable income before credit (L13-L14)			$46.10
16	US tax before credit (21% * L15)			$9.68
17	Foreign tax credit (L12)			$9.76
18	US Tax on GILTI (L16-L17)			$0.00

[1]Excess of gross income reduced by ECI, subpart F income, income that would be subpart F income but for high-tax exception and FOGEI, less allocable deductions

[2]Average of end-of-quarter adjusted bases in tangible depreciable property that generates tested income or loss, determined under ADS

Source: PwC.

GILTI | SALT Implications

If IRC §250 is considered a "special deduction," the impact of the corresponding deduction in IRC §250 is largely dependent on states' starting point for calculating state taxable income:

- Form 1120 line 28 – income before NOLs and special deductions vs. line 30 – income after NOLs and special deductions.
- If states adopt GILTI, but not the 50 percent GILTI deduction provided in Section 250, they will diverge from the federal approach to such income.
- Pre-TCJA, about two-fifths of the states with corporate income taxes conformed to line 28 of the federal income tax return. These states may need to clarify by statute or regulation that they adopt IRC Section 250.

GILTI | SALT Implications (cont.)

Factor Representation relating to the inclusion of GILTI income:

- States generally do not provide a foreign tax credit to offset GILTI income already taxed in a foreign country.
- Inclusion of foreign sales in the denominator of the receipts factor in single sales factor apportionment states allows for factor representation.
- Inclusion of foreign sales, property and payroll in the denominator of each factor in three factor apportionment states allows for factor representation.
- However, many states will need to enact legislation or promulgate regulations to provide for factor representation relating to GILTI income.

Foreign Commerce Clause Challenges

State income tax conformity with federal tax reform will result in a number of constitutional challenges:

- Provisions subject to challenge: Transition tax; GILTI; amortization of research and experimentation; BEAT (if adopted)
- Is the controlled foreign corporation (CFC) unitary with the U.S. filer?
- Discrimination against foreign commerce in favor of domestic commerce?
- Factor representation: is the inclusion of foreign income, but not corresponding apportionment factors of the CFCs unconstitutionally discriminatory
- Separate reporting vs. combined reporting state differences
- Other issues

Foreign Commerce Clause Challenges (cont.)

Separate Reporting State application:

- *Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Finance*, 505 U.S. 71 (1992).

Combined State application:

- *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Maine 1996).
- *Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993).