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Anticipating State Tax Ramifications of Federal Tax Reform

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Summary

Due to the current impact and the likelihood that states will consider legislation and agency guidance addressing federal tax reform implications for state business taxes, a united, effective, nationwide advocacy effort is needed to ensure the issues are consistently addressed on a multi-state basis. In preparation for anticipated ramifications, there is a need for a multi-state coalition.

In Depth

What Taxpayers Need to Know and Address

Federal tax reform will have a large impact on companies at the state tax level due to resulting increases in the state tax base and uncertainty surrounding application of the federal changes under state law. These problems exist because (i) current state provisions conforming or decoupling from federal law result in automatic expansion of the base; (ii) new legislation will expand the base; (iii) existing or new legislation fails to reduce the base in conformity with the federal changes; and (iv) existing law provides little guidance on definitions and taxable starting points related to tax reform. There is a real likelihood new categories of income subject to current taxation at the federal level will be subject to taxation at the state level, and new deductions will not be applied unless action is taken by state legislatures. There is also the likelihood states will decouple from new federal deductions for capital expenditures and flow-through businesses. Finally, questions such as what is a dividend and how to apply federal group calculations at the state level need swift and clear guidance from revenue authorities.

There is a possibility that states will consider legislation and agency guidance addressing federal tax reform implications for state business taxes. A united, nationwide advocacy effort is needed to ensure the issues are consistently addressed on a multi-state basis. In preparation for anticipated ramifications, a multi-state coalition will need to consider the following subjects.

Potential Issues

Deferred Foreign Earnings Transition Provisions

States could decide to include in state taxable income the federal deferred foreign earnings transition inclusion, even if they generally provide a deduction for Subpart F income or dividend-received deductions.

States could decide to tax the transition inclusion amount at the regular rate by requiring taxpayers add back the transition inclusion deduction.

Without any state action, any inclusion of previously deferred foreign earnings would be subject to tax entirely in one year, without the eight year installment payment election that is available at the federal level.

In determining the amount of previously deferred foreign earnings included in income at the federal level, netting is allowed among members of the consolidated group that have foreign corporations with positive earnings and profits (E&P) and members that have foreign corporations with negative E&P. Will this netting be allowed at the state level, especially in separate return states?

Coalition Focus

The previously deferred foreign earnings transition inclusion should not be included in the states' tax base because (a) it is not income paid to the domestic parent as a dividend; (b) inclusion of the transition amount could be unconstitutional without any apportionment factor representation; and (c) in separate return states, any inclusion of such income would be unconstitutional under *Kraft*.

If a state decides to include the transition amount in income, the Coalition will need to advocate that the deduction for the inclusion amount also must be available. In addition, the Coalition will need to advocate for some type of apportionment factor representation. For example, in single-sales factor states, the transition inclusion may be added to the denominator, but not the numerator.

Global Intangible Low Taxed Income (GILTI) Provisions

For some companies, there may not be a big GILTI impact at the federal level because foreign tax credits offset the bulk of the additional tax liability. However, for state tax purposes, foreign tax credits generally are not available, causing a potential increase in state tax liability even if there is no federal tax.

Because GILTI is not a category of Subpart F income, states could decide to include GILTI in state taxable income, even if they generally provide a deduction for Subpart F income. Any state or dividend-received deductions would likely not be available because GILTI is included in income regardless whether any dividend is actually paid.

The states could further expand their tax bases by requiring that taxpayers add-back the GILTI deduction.

Coalition Focus

The GILTI inclusion should not be included in the states' tax base because (a) it is not income that was actually paid as a dividend; (b) the GILTI inclusion likely would be unconstitutional without any apportionment factor representation; and (c) in separate return states, it is unconstitutional to tax the

GILTI inclusion under *Kraft*.

If a state does determine the GILTI inclusion must be included in the tax base, the GILTI deduction also should be allowed and there should be some type of apportionment factor representation.

Foreign Derived Intangible Income (FDII) Provisions

States may require that the FDII deduction be added back.

Possible Focus for Coalition

FDII income is domestic income from the foreign exploitation of intangible property. To the extent the states require the FDII deduction be added back, the Coalition should focus on possible apportionment formula allowances because the FDII is income from customers located outside of the country.

Interest Expense Limitation

It is uncertain how the interest expense limitation will apply at the state level, and how it will interact with the state tax addbacks.

Coalition Focus

Due to the current state limitations on the deductibility of interest paid to a related party, there is no need to also apply the federal interest expense limitations at the state level.

If a version of the federal interest limitations is imposed at the state level, the Coalition can advocate for use of a reasonable method for limiting interest expense and for reasonable interaction of any interest limitation with any state tax add-back provisions.

Expensing Provisions

It may be necessary to convince states to adopt the federal expensing provisions; because of the magnitude of the state hit from not decoupling from 100 percent expensing, the Coalition should come up with some consistent approach to decoupling.

Net Operating Loss (NOL) Provisions

Efforts may be needed to convince states not to mimic the federal changes and impose an 80 percent limitation on NOLs and, in some instances, to retain existing state carryback provisions. To the extent that state NOLs are limited by federal group usage, provisions protecting NOLs based on group differences should be adopted.

Base Erosion Alternative Minimum Tax

States may attempt to enact a similar alternative minimum tax. Focus would be on demonstrating the unconstitutionality of any such provision.

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