State Tax Implications of Federal Tax Reform: The Business Perspective

Multistate Tax Commission 51st Annual Meeting

Boston, Massachusetts

July 25, 2018

Presenters:

Karl Frieden, VP/General Counsel, COST (Moderator)

Deborah Bierbaum, AVP Tax Policy, AT&T Services Inc.

Susan Courson-Smith, Senior Director Global Tax, Pfizer Inc.

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

Tax Cuts and Jobs Act (TCJA) – Transformative Changes

– **The TCJA signed into law in December 2017 enacted the most comprehensive overhaul of the Internal Revenue Code in 30 years.**

- Moves the U.S. from a worldwide to a quasi-territorial tax system consistent with U.S. trading partners. As a one-time cost of moving to a quasi-territorial system, imposes a transition tax on 30 years of accumulated foreign earnings.
- Enacts new foreign source tax provisions intended to raise money to offset tax cuts and tilt the playing field to favor domestic commerce over foreign commerce (e.g. GILTI, BEAT, FDII).
- Over 10 years provides for $6 trillion of tax cuts offset by $4.5 trillion of tax increases.
- Made other significant changes including 100% expensing, interest deduction limitations, special pass through entity deduction, limitation on state and local tax deductions and general base broadening.

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 <u>inadvertent and arbitrary</u>: 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.**
- **As a general principle, conformity with federal laws can facilitate taxpayer compliance and reduce taxpayer burdens.**
  - However, many of the provisions relating to international tax reforms and the interest limitations raise unique issues that states need to consider as part of their responses to federal tax reform.

Top Increases and Decreases in Federal Corporate Tax Base with TCJA and Potential State Conformity

Business Tax Provision	% Change in Federal Corporate Tax Base	State Conformity
One-time transition tax on unrepatriated foreign earnings	+ 9 %	Partial conformity (but typically of 25% or less)
Net interest expense limitation (30% of ATI)	+ 6.4%	Mostly conformity
Global intangible low-taxed income (GILTI)	+ 5.5 % (gross)	Mostly conformity
Modification of net operating loss deduction	+ 5.3%	States have own provisions
Base Erosion and Anti-Abuse Tax (BEAT)	+ 4.0%	Non-conformity
Amortization of research and experimental expenditures	+ 2.9%	Conformity
Repeal of domestic production activities deduction	+ 1.9%	Partial conformity
Foreign derived intangible income (FDII) deduction	- 1.7%	Mostly conformity (but §250 issue)
Expensing provided under Section 168(k) bonus depreciation	- 1.8%	Limited conformity
Global intangible low-taxed income (GILTI) deduction	- 2.6%	Mostly conformity (but §250 issue)
100% foreign DRD	- 5.9%	States have own provisions

Key TCJA Corporate Tax Provisions Impacting the States

IRC §163(j) Interest Expense Limitation

- **IRC §163(j) interest expense limitation applies to both third party and related party interest.**

- **IRC §163(j) will not work the same for state purposes as federal purposes.**
  - TCJA coupled the interest expense limitation to 100% expensing for cost of capital. Most states do not conform to 100% expensing.
  - TCJA calculates the limitation on the consolidated federal group basis. In many states, the combined group differs from the federal group, or companies file on a separate entity basis.
  - Separate state tax regimes for classes of taxpayers can create distortions and limitations, even when none exist at the federal level.
  - Existing state interest limitations for intercompany debt overlap with the federal limitation.

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.
  - 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.

- **IRC §965(a) deemed mandatory repatriation.**
  - Does not represent a return of cash; the 30 years of accumulated foreign earnings include amounts invested in a company's foreign active business.
  - Does not represent a revenue loss for states, as it represents foreign income not previously taxed by states.

Transition Tax State Issues

- **Apportionment and factor representation issues.**
  - As the “deemed” dividends represent 30 years of earnings, what would adequately provide factor representation?
  - 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 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.**
  - Should the federal net earnings and profits be allocated among the group members?
  - Should taxpayers prepare separate E&P calculations based on the state filer, which could result in state specific “deemed” dividends different than the federal amount?

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.
- **States that tax GILTI without considering foreign tax credits, will be indiscriminately taxing both high and low-taxed foreign income.**

Is GILTI Really Guilty?

- **For Federal:**
  - **Global:**

    Yes. It includes all global income earned by the taxpayer’s foreign subsidiaries.
  - **Intangible:**

    No. It is not limited to income from intangible property, it also includes active trade and business income such as services and a portion of tangible property.
  - **Low-Taxed:**

    No. Foreign tax credit allocation issues can result in GILTI applying at the federal level in high tax foreign jurisdictions.
- **For States Additional Issues Exist:**
  - **GILTI taxed at 50% federally but could be 100% at state:**

    If states include GILTI IRC §951A income without allowing the 50% deduction under §250(a)(1)(B)), they will tax 100% of GILTI income.
  - **No Offset for Foreign Taxes Paid:**

    States do not conform to federal foreign tax credits, which can lead to indiscriminately taxing both high and low-taxed foreign income.

GILTI: Apportionment Considerations

– **Factor Representation relating to the inclusion of GILTI income:**

  - 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.

  - States may need to provide clarity either through legislation or 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 expenditures: 5 years for domestic/ 15 years for foreign.
  - 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 without corresponding apportionment factors of the CFCs unconstitutionally discriminatory?

Taxpayers Need TCJA Guidance in 2018

Taxpayers have both 2018 financial reporting requirements and statutory tax requirements related to the state treatment of TCJA.

- **Financial Reporting Requirement Considerations (SAB 118)**
  - **Accounting Standards Codification (ASC) 740:** Requires companies to account for the effects of changes in income tax rates and laws on deferred balances (including the effect of the TCJA one-time mandatory repatriation) in the period legislation is enacted.
  - **SEC Staff Accounting Bulletin No. 188 (SAB 118):** The SEC recognized how complex the federal tax reform provisions were and issued SAB 118, which provides companies a 12-month period to report the full financial statement implications of the TCJA. That 12-month period ends in December, 2018.

Taxpayers Need TCJA Guidance in 2018

- **Statutory Tax Requirements**
  - **IRC §965(a):** The mandatory one-time deemed repatriation is effective for 2017, and most extended 2017 state returns are due in September or October 2018.
  - **IRC §951A and IRC §250(a)(1)(B)):** The GILTI provisions are effective for 2018 and most taxpayers are required to compute and submit quarterly estimates.
  - **IRC §163(j):** The interest limitation provisions are effective for 2018 and most taxpayers are required to compute and submit quarterly estimates.

State Tax Budget Considerations

State Tax Budget Considerations

- **Potential increase in state corporate income taxes from conformity with the Tax Cuts and Jobs Act (TCJA)**
  - $6 to $8 billion estimated annual state corporate income tax revenue increase from state conformity with the TCJA (COST/EY study)

- **Additional sales tax revenue expected from the Wayfair decision (and overruling *Quill):***
  - $8 billion to $33 billion estimated annual sales tax revenue increase (SCOTUS Wayfair decision)

- **Will the expected state revenue from TCJA and *Wayfair* provide an opportunity for real state tax reform?**

Appendix A: Beyond the Water’s Edge

Pre-TCJA State Taxation of Foreign Source Income: The Water’s Edge

- **States generally did not follow the former 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

Post-TCJA State Taxation of Foreign Source Income: Beyond the Water's Edge

- **Transition Tax on Foreign Deferred Income:**
  - Subjects 30-years of foreign earnings and profits to taxation.
- **Global Intangible Low-Taxed Income (GILTI):**
  - Subjects future foreign earnings to taxation in the year earned.

Examples of State Decoupling from IRC §965(a) *

- **State legislation passed to decouple from Transition Tax**
  - Georgia (HB 918)
  - Florida (HB 7093)
  - Michigan (SB748)
  - Hawaii (SB2821)
  - Iowa (SF 2417)
  - Wisconsin (AB259)
  - New York (SB7509)
  - North Carolina (SB 99)
  - West Virginia (HB4135)
  - Kentucky (HB 487/HB366)
  - Virginia (HB154/SB230)
  - Connecticut (SB 11, along with guidance that 95% DRD applies)
  - New Jersey (AB4202 – 95% DRD with limitation on apportionment)
  - Indiana (HB1316 – 50-100% DRD)

  **IRC §965(a) Transition tax is exempt under current law for many states therefore no new legislation was required in those states to exempt IRC §965(a) .*

- **States administrative guidance issued to exclude IRC §965(a) Transition income from state tax base**
  - **Tennessee** (Tennessee Important Notice No. 18-05, 04/01/2018)
  - **Florida** (Florida Tax Information Publication No. 18C01-01, 04/27/2018)

(List is not all inclusive)

Examples of State Decoupling from IRC §951A

- **Decoupling (to date) from GILTI**
  - Arizona (HB 2647)
  - Georgia (SB 328)
  - Hawaii (SB 2821)
  - Indiana (HB 1316)
  - Michigan (SB 748)
  - North Carolina (SB 99)
  - Virginia (HB 154/SB 230)
  - Wisconsin (AB 259)
  - Illinois (no conformity due to preexisting law)
  - Montana (no conformity due to preexisting law)
  - South Carolina (no conformity due to preexisting law)

(List is not all inclusive)