MULTISTATE TAX COMMISSION

Uniformity Committee
Impacts of Federal Tax Reform on State Income Taxes

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*This summary is not intended to be relied upon as legal advice ; it is intended to be a general summary of current state and federal statutes; those statutes speak for themselves. Further, the comments and opinions expressed herein are of the authors alone and do not necessarily reflect the opinions or positions of the Multistate Tax Commission or its member states.

The Federal Jobs and Tax Cut Act

Summary of Key of Federal Tax Changes Affecting Multistate Taxation

Automatic or Potential State Conformity in Red (for tax years beginning 1/1/18)

Key Domestic Tax Base Changes

- Corporate tax rate reduction from 35% to 21%.—**non conformity**
- Allow 100% expensing of investments for five years (up from 50% bonus depreciation) with a phase-down in later years—**Limited conformity.**
- Limit interest expense deductions to 30% of corporation's adjusted taxable income (ATI), with carryforward—**state conformity-may require clarification.**

Domestic Tax Base Changes Cont.

- Net operating losses limited to 80% of taxable income with an indefinite carry forward (but no carryback)—**Potential conformity in many states—but will require clarification.**
- Amortization of research and experimental expenditures (previously expensed)—**state conformity in most states.**
- Repeal the domestic production deduction—**state conformity in most states.**
- 20 percent deduction for pass-through entity income at individual income tax level--**state conformity in some "federal net income" states—most states will not conform.**

Changes Affecting Taxation of Multinational Corporate Income

The Big Picture: Change from Residency/Territorial to Pure Territorial System.

Before 2017: U.S. Corporations taxed on worldwide Income; credit for foreign taxes paid;

Exception: Subpart F Rules: Passive income of CFC's in "low tax" countries included in tax base;

Foreign dividends include in base (with gross up to reflect foreign taxes deducted)

Foreign Entities: U.S. Source Income taxable (required permanent establishment in U.S.)

Changes Affecting Taxation of Multinational Corporate Income

The New Territorial System:

U.S. corporations taxed only on domestic-source income; Automatic conformity in most states (except taxpayers electing WWCR)

Exception: foreign-derived intangible income (FDII) of a domestic company: taxed at reduced rate under IRC 250. State conformity unclear; state conformity to special deduction reduced rate in "line 30" states; unclear conformity in Line 28 states.

100% Deduction for Foreign-Source Dividends--No state conformity, but most states already exclude most or all dividends from the base;

Subpart F Income remains—but states exclude most or all Subpart F income from base.

One-time Repatriation of Accumulated Untaxed Earnings for 2017--taxed under Subpart F; most states will exclude most or all income

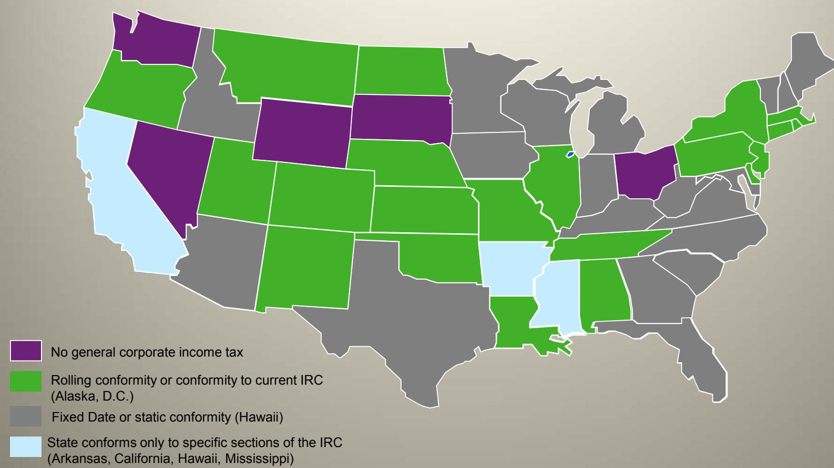
New Tax Imposition: Global Intangible Low Taxed Income—GILTI—

most states will automatically conform, but legislation advisable—

Deduction for Foreign-Derived Intangible Income (FDII)-state conformity to IRC 250 deduction unclear

Base Erosion Anti-Abuse Tax ("BEAT"). States will not automatically conform.

General state conformity to the Internal Revenue Code



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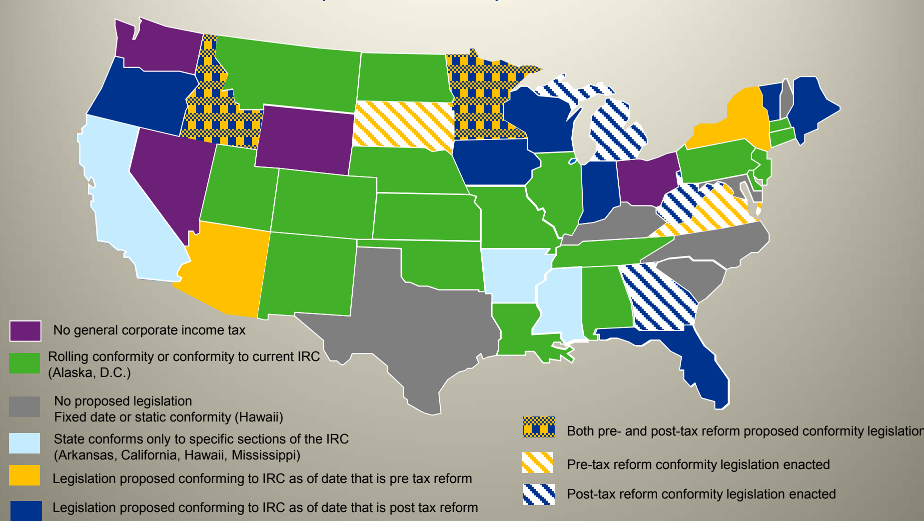
Proposed legislation for conforming to the Internal Revenue Code (as of 3/6/18)



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IRC 163(j) Limitation of Interest Expense

Under the new federal code effective for tax years 2018 and forward, business interest expense cannot exceed 30% of FTI exclusive of business interest income, business interest expense, depreciation, amortization. The federal limitation treats the consolidated group as a single entity for purposes of the limitation. There are several exceptions, including inventory financing. **Most states will automatically conform to the new limitations.** States with interest expense add-back statutes may have to determine how to apply the limitations. Georgia and Wisconsin have decoupled. According to a recent estimate from South Carolina, the federal provision would raise revenue by $12 million per year. JCT Score: $90 Billion for 5 years.

Net Operating Loss Limitation IRC 172(a) & (b)

- Limits NOL deductions to 80% of current taxable income; federal carrybacks eliminated but carryforward years unlimited. **State conformity will vary significantly**. Some states reference IRC 172 (“federal amount conformity”) while other states use “federal method” conformity and adjust for post-apportioned income. Most states have already decoupled from federal carryback and carryforward provisions.
- States may want to consider using the federal changes as an opportunity to review their NOL statutes, rules and policies.
- JCT Score: $68 Billion over 5 years.

Mandatory repatriation (IRC § 965)

Deemed inclusion of undistributed, non previously taxed post 1986 foreign earnings of a CFC

This is the international tax issue with the biggest potential revenue implication—or the issue which could have the largest revenue impact, except that the income is repatriated under Subpart F income rules.

JCT Estimates: Treatment of deferred foreign income upon transition to participation exemption system of taxation and mandatory inclusion at two-tier rate (8-percent rate for illiquid assets, 15.5-percent rate for liquid assets):

2017: 78.6 2018: 49.6 2019: 16.5 2020: 15.6 2021: 15.7 2022: 27.2 2023: 47.5 2024: 64.4 2025: 33.0 2026: -9.4 2027: 176.0 Total: **$338.8 Billion**

State Estimates and Responses to Repatriation Issue

New York: expects significant revenue increase for disallowed expenses associated with non-taxed income

Idaho: enacted legislation

- Updated static conformity date to include deemed repatriation
- Requires addition to state taxable income for 965(c) deduction
- Applying 80% state DRD, Idaho taxes 20% of 965(a) amount

Connecticut: proposed legislation

- State requires add-back for expenses related to excluded dividends
- Proposal would assume expenses are 10% of excluded dividend, retroactive to 2017
- Effectively includes 10% of deemed repatriation in tax base

Massachusetts: revenue estimate

- 95% state DRD; estimated deemed repatriation revenue at $65m
- Also estimated revenue applying less-than-95% DRD

More State Responses:

Georgia: Enacted legislation excluding Repatriation income

Minnesota: taxes 20% of Subpart F; expecting significant revenue increases

California: taxes 20% of Subpart F income, but tax credits are expected to offset most revenue gains.

Illinois: clarifies no repatriation income is included in base sinc Subpart F income is entirely excluded .

But Where is the Revenue?

Some states (e.g., Connecticut) are seeing significant uptick in personal income tax estimated payments for 2017 that may be attributed to repatriation income;

Some states are apparently not seeing a similar uptick in estimated payments for 2017 corporate tax liability.

Why Aren't States Awash in Repatriation Income ?

Currently, Subpart F is generally excluded from the corporate tax base, as a result of economic development decisions and arguable impact of Kraft decision (see below).

Since domestic dividends have always been in the federal tax base for individuals, Kraft has no application. Some states, especially Connecticut, have reported significant uptick in personal income tax estimated payments for 2017 that may be attributed to repatriation income;

Kraft General Foods v. Iowa (1992) held that states could not tax corporations' foreign dividends while excluding domestic dividends from tax base;

Kraft fn. 23: "hard-pressed" to see similar facial discrimination for water's edge combined filing states;

Subpart F isn't an actual foreign dividend—*Kraft* may not apply since no identical domestic equivalent;

Should states revisit their subpart F exclusion policies—retroactively to 2017?

Should states impose a surtax on installment payments?

If states do fully tax repatriation amounts, what would factor relief look like?

GILTI (IRC§951A)

New category of income, similar to Sub F, deemed repatriated at year end.

GILTI is explicitly not Subpart F income, although included in base under same mechanism;

JTC Five Year Revenue Estimate: $49 Billion

Explanation of GILTI

- **"In simplest terms, GILTI is the excess of a CFC's net income over an assumed return on CFC's depreciable tangible property and certain interest expense."**
- **GILTI** equals the US shareholder's share of (i) net CFC tested income, less (ii) net deemed tangible income return.

Net CFC tested income of a US shareholder means the US shareholder's pro rata share of (i) the total tested income of each CFC, less (ii) the total tested loss of each CFC.

- **Tested income** of a CFC equals (i) its gross income, less (ii) ECI, Subpart F, income that would be Subpart F or insurance income but for the high-tax exception, related party dividend income and FOGEI (foreign oil and gas extraction income), less (ii) deductions (including taxes) properly allocable to such gross income."

(Ed. Note: the above explanation is taken from recent ABA presentation by Dianne Mehany, et. al.)

More on GILTI

Georgia has passed legislation specifying GITLI is part of tax base; will other states follow?

Taxpayers may argue income is not apportionable, or may change ownership of CFC's to non-nexus entities or 80/20 excluded entities.

Taxpayers may argue that Kraft requires exclusion of GILTI income amounts.

IRC 250A has complicated deduction intended to reduce effective tax rate;

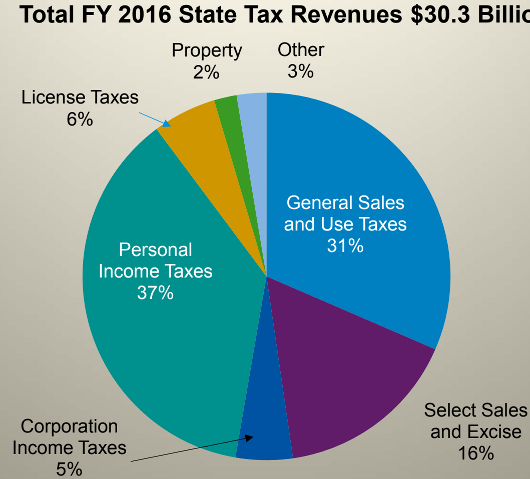
Could states see taxpayers claiming IRC 250 deduction on untaxed income?

Deduction for Foreign-Derived Intangible Income

A complex deduction under new IRC 250A based on an assumed rate of return for overseas sales of TPP, assuming any return above that amount is attributable to domestic creation of intangible values. Allows a 37.5% deduction on those profits, declining to 22% after 2025. Intended to reward domestic R&D. The deduction will presumably be a special deduction under line 29a. State conformity unclear.

Sources of state tax revenues

Total FY 2016 State Tax Revenues $30.3 Billion



Source: US Census Bureau, 2016 State Government Tax Collections

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State reactions

Majority of reactions and comments

- Governors and legislative leaders prioritizing the impact of federal tax reform to individual income taxes
  - Several states proposing workaround to the SALT deduction cap
    - Creation of state charitable funds
    - Potentially restructuring personal income taxes
- Governors of four Northeast states (Connecticut, Maryland, New Jersey, and New York) plan to sue the federal government over the new tax law
- States are beginning to release preliminary estimates of the impact to state budgets from federal tax reform

Workaround to SALT deduction cap

State	Charitable contribution funds	Payroll tax system	Pass through entity tax
California	✓		
Connecticut	✓		✓
Illinois	✓		
Maryland	✓		
Nebraska	✓		
New Jersey	✓		
New York	✓	✓	
Oregon	✓		
Rhode Island	✓		
Virginia	✓		
Washington	✓ *(Sales Tax)*		

State IRC conformity legislation (as of 3/6/2018)

Pre Federal Tax Reform	Post Federal Tax Reform
Arizona	**Florida**
Idaho *Enacted both pre- and post-tax reform bills, with modifications (and has several other bills pending)*	
Minnesota *(there are 3 pre-tax reform bills and 2 post-tax reform bills)*	**Georgia** *Enacted*
New York *Rolling conformity (automatic adoption without action)*	**Hawaii**
Virginia *Enacted*	**Indiana**
	Iowa
	Maine
	Michigan *Enacted* *Or at the option of the taxpayer, in effect for the tax year*
	Oregon
	South Dakota *Enacted*
	Vermont
	West Virginia *Enacted*
	Wisconsin

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Proposed rate reduction legislation (as of 03/07/18)

State	Individual Income Tax	Corporate Income Tax
Colorado	✓	✓
Connecticut		✓
Florida		✓
Georgia		✓ (enacted)
Idaho		✓
Illinois		✓
Iowa	✓	✓
Maryland		✓
Minnesota		✓ (repeals AMT)
Missouri		✓
Nebraska		✓
Rhode Island	✓ (pass-through withholding rate)	
Utah		✓
Virginia		✓
Washington		✓ (B&O tax on manufacturing)