KPMG

What Federal Reform Means for States and State Taxpayers?

2017 Winter/Spring MTC Litigation Committee Meeting

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Overview

General contours of “The Plans”

President Trump

15 percent corporate rate

Election to expense or retain interest deduction

Repeal variety of deductions, credits and preferences

Deemed foreign dividend repatriation with 10 percent rate

Address issue of neutralizing tax burden on imports

Uncertain on intended revenue effect

House Republican Blueprint

20 percent corporate rate

Immediate expensing of assets

Eliminate deduction for net interest expense

Eliminate NOL carryback; allow indefinite carryforward with 90 percent offset of ATI

Move to destination based cash flow tax with base of receipts minus purchases source to place of consumption

Allow deduction for wages

Includes border tax adjustment to exclude exports and disallow deduction for imports

Move to territorial system internationally

Intended to be revenue neutral

Connection between federal and state taxes

Why does federal reform affect state corporate income taxes?

- Almost all states start the computation of state corporate taxable income with federal taxable income
  - Generally, either Line 28 or Line 30, subject to state-specific modifications
    - Common decoupling modifications include bonus depreciation, IRC section 199 deduction
  - Thus, federal changes that affect the computation of federal taxable income (or Adjusted Gross Income on the personal income tax side) will affect state taxes if the state adopts the change
  - Most changes in tax credits will not affect states; States typically adopt their own state-specific incentives
    - States sometimes allow a counterpart credit based on the federal credit, e.g., research and development or child and dependent care (personal)
  - Conformity to IRC generally serves interests of both state tax administration and taxpayer compliance

When will federal tax reform not affect state taxes?

- Keep in mind that certain states impose gross-receipts taxes in lieu of corporate income taxes (NV, OH, WA)

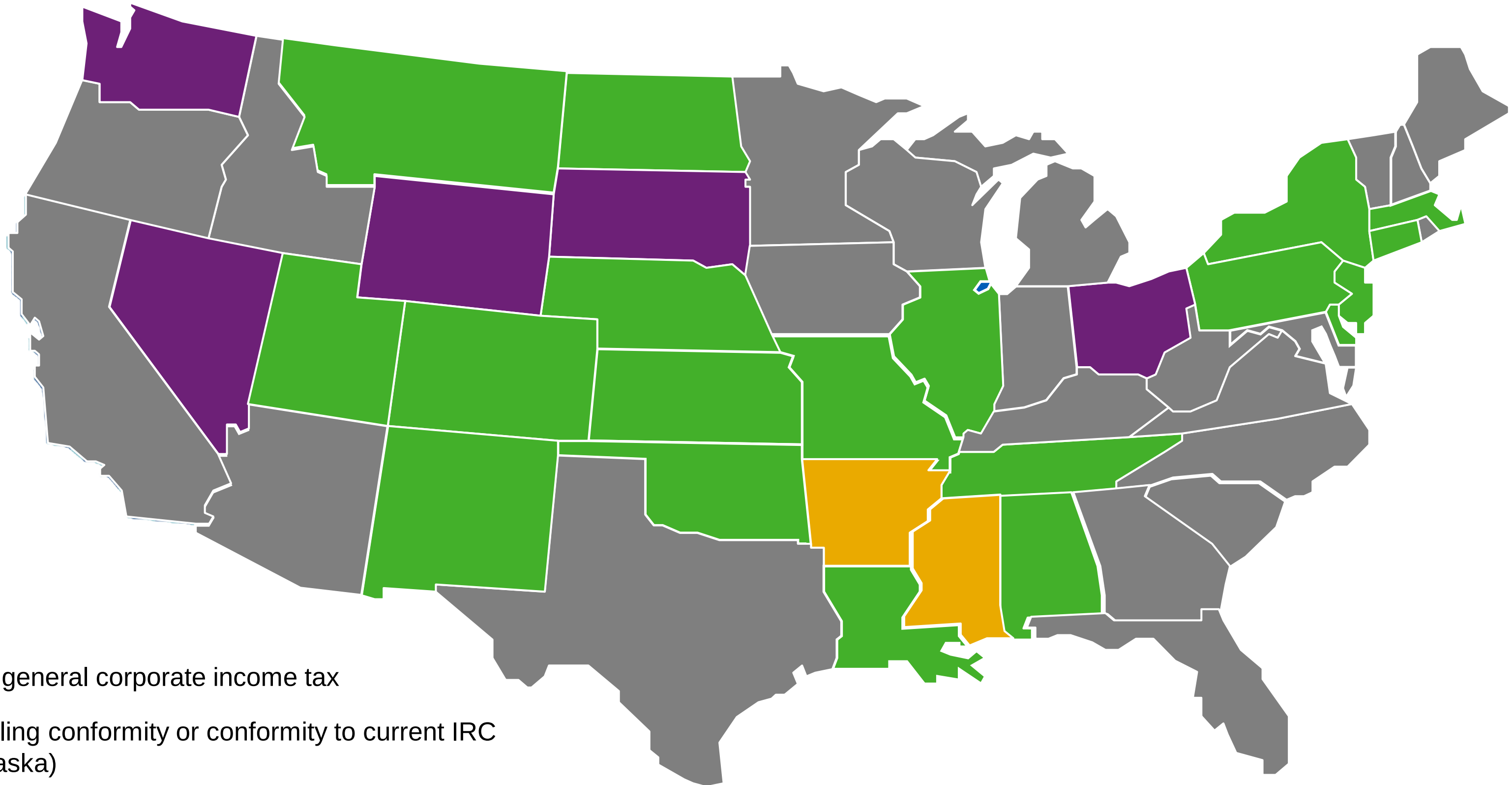
Conformity considerations

How do states conform to the Internal Revenue Code?

- “Moving” or “rolling” conformity states- these states adopt the IRC as currently in effect for the tax year in question
  - All federal changes will be automatically incorporated into the state’s law unless a specific decoupling modification is enacted

- “Fixed-date” or “static” conformity states- these states conform to IRC as of a certain date
  - For example, if a state conforms to the IRC as of January 1, 2014, the state does not adopt any federal tax changes that occurred after that date that would go into the computation of “federal taxable income” or other features to which the state conforms
  - Most fixed-date states (notable exception is California) update their conformity regularly during the state’s legislative session

State IRC conformity



No general corporate income tax

Rolling conformity or conformity to current IRC (Alaska)

Fixed Date or static conformity (Hawaii)

State conforms only to specific sections of the code

Source: Federation of Tax Administrators

Why conform

Conformity generally serves purposes of both taxpayers and state tax administrators

- For taxpayers is primarily an issue of simplicity, ease of compliance and availability of information
  - Consistent tax base
  - Deviations from base based on known amounts (e.g., exclude select items in federal base
  - Single set of definitions, guidance, etc. as to major features
- For tax administrators/states is primarily an issue of simplification as well as compliance and enforcement
  - Can rely on federal definitions, guidance, etc.
  - Information and simplicity improve the ability of taxpayers to comply and “get it right”
  - Rely on or benefit from IRS for information reporting and compliance efforts
- Consequences of non-conformity are increased complexity and potentially decreased compliance

Timing is everything

What are the potential timing issues states may face?

- Moving conformity states will adopt tax reform changes automatically; Fixed-date conformity states will not
  - So, moving conformity states will conform to tax reform changes unless they decouple, but fixed-date states will not conform unless they update their conformity accordingly
- Timing could be an issue- as it is not yet clear when federal tax reform will be enacted OR when it will be effective
  - Most state legislatures convene and adjourn within a few months during the first part of the year
    - Some states have very short sessions and federal tax reform may be enacted after the state legislature has adjourned
    - Depending on the effective date- states may have to convene a special session to address tax reform changes or put off addressing until the following year

Implications of Specific Provisions

State implications of specific provisions

Corporate income tax rate changes

- Both the Trump Plan and the House Blueprint would reduce corporate income tax rates
  - Rates would drop to 15 percent under the Trump Plan and 20 percent under the House Blueprint
- No direct bearing on the states; States do not compute state corporate income taxes as a percentage of federal tax liability

Immediate expensing of certain assets

- Both plans envision reducing the after-tax cost of business investment by allowing the acquisition of certain assets to be immediately expensed instead of depreciated over time
  - Because immediate expensing would affect federal taxable income; it would affect the computation of state taxable income unless the state decoupled (assuming conformity to the Code in the year reform is enacted)
  - Important to note that states have widely decoupled from other federal efforts to stimulate investment by accelerating depreciation or allowing immediate expensing
- In terms of changes to base, expensing is the largest at the federal level from a revenue perspective
  - At state level, any revenue impact is comparatively greater because of current non-conformity on bonus depreciation

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  - Continued non-conformity will require states to maintain their own capital cost recovery system as federal government moves away
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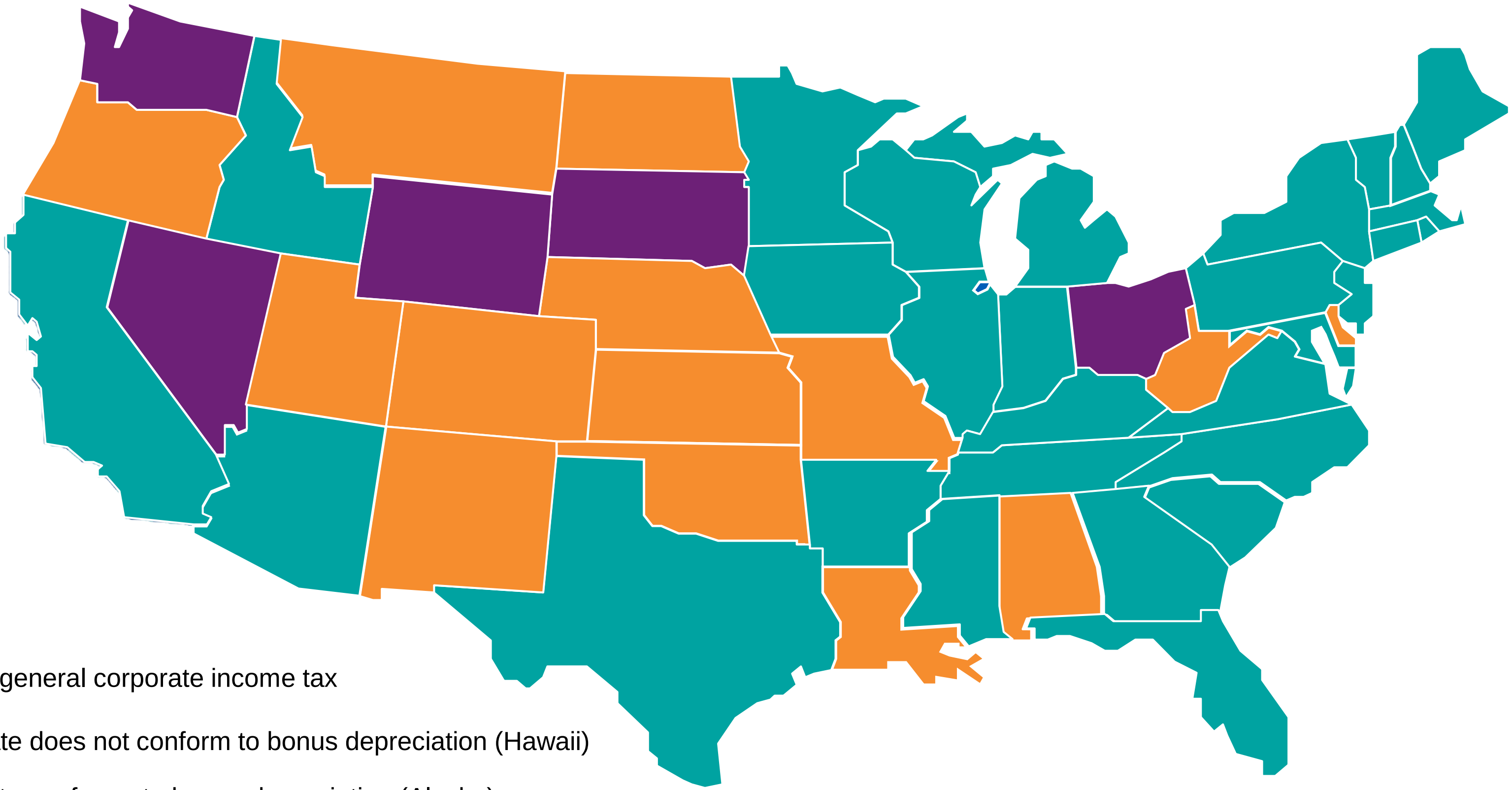
States decoupling from bonus depreciation- TIPA 2014



No general corporate income tax

State does not conform to bonus depreciation (Hawaii)

State conforms to bonus depreciation (Alaska)

Source: Thomson Reuters

State implications of specific provisions

Disallowing deduction of certain interest expenses

- House plan would allow businesses to deduct interest expense only to the extent it is netted against interest income, with any net interest expense beyond that being carried forward indefinitely
- Again, to the extent this change affects computation of federal taxable income it will flow through to states
- With conformity, degree of complexity will depend somewhat on how implemented, i.e., at consolidated group level or entity-by-entity.
- It is unclear how these federal limits would co-exist with limits on the deductibility of related party interest that are currently applied in a number of states
  - Proposed disallowance applies to all interest expense – not just interest paid to a related party and there are no exceptions

State implications of specific provisions

Revising net operating loss (NOL) deductions

- Under the House Blueprint, NOLs could be carried forward indefinitely, but not carried back; the NOL carryforward deduction limited to 90 percent of net taxable income
- Many states require computation of a state specific NOL, which (similar to federal) has a specific carryforward and/or carryback period
  - A number of states disallow carrybacks altogether and/or deviate from the current 20 year federal carryforward period
  - Because the computation of state NOLs deviates from federal practice, tracking state NOLs will likely continue to be difficult
  - Current degree of non-conformity may decrease interest in conforming on a go-forward basis

State implications of specific provisions

Cash flow tax and border tax adjustment

House Blueprint would move the U.S. away from a net income tax to a destination-based cash-flow tax, or consumption tax, with a base (essentially) of receipts minus purchases of goods and services from other firms and minus compensation paid

- The proposal includes a "border tax adjustment" (BTA) that is intended replicate BTAs under a VAT and treat the choice of whether to import a product or use a domestic product as part of the supply chain neutrally with respect to tax
  - The adjustment seems likely to be implemented as an exclusion from the federal tax base for exports and the disallowance of deductions for imports
- As that is the new tax base, the BTA would flow through to those states that conformed to the new tax and base
- The border tax adjustment is one of the main revenue-raising provisions (along with net interest expense disallowance) in the Blueprint that offsets the revenue impact of the reduced federal tax rate, expensing, etc.
- Without the BTA, the cash flow tax would resemble the Texas Margin Tax to a considerable degree

State implications of specific provisions

Repatriation of deferred foreign earnings

- Both the President's plan and the Blueprint would impose a one-time, reduced tax rate on deferred foreign earnings of U.S. companies that have not been repatriated
- Under the Blueprint, an 8.75 percent tax would be imposed on accumulated foreign earnings held in cash or cash equivalents and a 3.5 percent tax on all other accumulated foreign earnings
  - Companies could pay the tax on repatriated earnings over an eight-year period
- Under the Trump plan, accumulated offshore earnings would be subject to a one-time 10 percent tax
- It is unclear how these taxes would be implemented (i.e., would such earnings be subject to a separate stand-alone tax, or would they be included in the federal tax base)
  - In the past, a similar repatriation tax was accomplished by allowing an 85 percent dividends-received deduction
- If the tax reform treatment for repatriated earnings is likewise accomplished through a dividends-received deduction, then a host of state issues arise
  - E.g., Nexus of payee, co-ordination with the state's own dividends-received deduction, treatment in combined reporting states, characterization of the dividends as business or non-business income, etc.

State implications of specific provisions

Shift the international tax system to a territorial one

- The Blueprint proposes to eliminate the current system of taxing U.S. companies on worldwide earnings (with deferral) to a territorial one where the tax is imposed on U.S.-sourced earnings
- Blueprint proposals include allowing an unlimited dividends received deduction for dividends from foreign subsidiaries and repealing most of the current Subpart F rules
- The impact on states will, of course, depend on their current treatment of foreign source income and foreign operations, but repeal of the Subpart F regime could affect a number of states
- The interaction of these proposals with those states that require or allow worldwide combined reporting will require examination
- Movement in this direction, in conjunction with the movement to the cash flow tax (i.e., taxing where consumption occurs as opposed to where production occurs) raises certain issues with which states have considerable experience – namely the sourcing of receipts of various sources and how to determine where “consumption” occurs

State implications of specific provisions

Other proposals

- Not many specifics, but both plans would repeal a variety of special interest tax preferences
  - Would affect state tax liability if the preference was a deduction allowed by the state
  - Again, repeal of federal credits likely won't widely affect states
- Tax pass-through income at a lower rate
  - Again, rate changes will not directly affect states
  - Few states differentiate rates between individual rates and rates on pass-through income
- Individual income tax changes
  - Given the sheer number of individual income taxpayers, may be more likely to see states conform their personal income tax regimes to a new federal one
  - Repealing the itemized deduction for state and local taxes would increase the "after tax" cost of state and local services, particularly for taxpayers in states with high personal income tax rates
  - Big revenue raiser on federal side is the repeal of the personal exemption allowance; states generally maintain their own personal exemptions and standard deductions

Things to consider…..

States are already considering tax reforms

- Federal tax reform is not going to stop state legislators from considering and adopting tax changes during the 2017 legislative sessions
    - So, be prepared for the usual plethora of state tax law changes

States are generally required to balance their budgets

- Many states are currently facing budget shortfalls
- Federal tax reforms that reduce revenues flowing to the states may not be fiscally feasible for the state to adopt- particularly on the personal income tax side
    - Approximately 35-40 percent of total state tax revenues come from individual income taxes, as compared to about 6 percent from corporate income taxes

It will be challenging for states to analyze the effect of certain federal changes, particularly with respect to business taxes

- State reactions may be delayed
- Dealing with dynamic scoring will be challenging for states

Things to consider… (Cont.)

Revenue impact at the state level

- If a state were to conform to all federal changes, the resulting state tax base (both personal and corporate) would likely be broader than current law, thus making accommodation of rate reductions possible while maintaining revenue neutrality
- It would seem unrealistic to expect that state rate reductions would be of the same relative magnitude as those proposed by the President or in the Blueprint
  - The expensing provision especially will have a greater comparative impact on states where they currently do not conform to bonus depreciation
  - Repeal of most tax preferences will not have a flow-through effect to the states
  - There are some provisions that work in the other direction (ACA taxes, AMTs)
  - “Dynamic scoring” is a wild card for states
  - Fiscal conditions and balanced budget requirements may well argue for delay
- That said, Republicans control a majority of state legislatures and the trend has been for state Republican leaders to drive down income tax rates

Conclusion

Federal tax reform will create a considerable period of significant uncertainty for state corporate income taxpayers

Beyond the uncertainty, the complexity for multistate taxpayers will undoubtedly increase for some period as states adjust to federal changes

There will be a premium on understanding one's current tax profile and monitoring activities in important states

Thank you

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