THE TAX CUTS AND JOBS ACT (TCJA)
FEDERAL TAX REFORM AND THE EFFECTS ON STATES

Strong States, Strong Nation

January 12, 2018
Today’s webinar will be recorded and the registrants will be able to access the recording and the referenced materials on NCSL’s website.

Resources are available by clicking on the “Media Library” icon at the top of the screen.

If you have any questions, please type them into the text box located in the bottom left-hand corner of the screen, which our speakers will address throughout the webinar as well as during the Questions and Answers period following the presentations.

Resources: NCSL Webpage: Federal Tax Reform and the States
Webinar Overview

❖ Max Behlke, director, Budget and Tax, State-Federal Relations Division, National Conference of State Legislatures (Moderator)
❖ Steve Wlodychak, principal, Ernst & Young, Washington, D.C.
❖ Harley Duncan, tax managing director, State and Local Tax, KPMG, Washington, D.C.
❖ Heath Holloway, deputy director, Fiscal and Management Analysis, Indiana Legislative Services Agency
❖ Q&A
June 24, 2016 - House GOP released their vision for tax reform (the “Blueprint”).

April 26, 2017 - President Trump released his overall vision for business tax reform.


Nov. 2, 2017 - The House Ways and Means Committee released legislation, the “Tax Cuts and Jobs Act” (H.R.1) (“TCJA”), which totaled 429 pages.

Nov. 9, 2017 - The Senate released its tax reform proposal.

Nov. 16, 2017 - The House passed its tax reform bill 227-205

Dec. 2, 2017 - The Senate passed its tax reform bill 51-29

Dec. 15, 2017 - Reported by Joint Conference Committee

Dec. 20, 2017 - Final bill passed both chambers

Dec. 22, 2017 - President Trump signs the TCJA (H.R. 1) into law. (P.L. 115-97)
Highlights of the new law

Individual:
- Rates and Brackets
- Standard deduction
- Personal exemptions
- Itemized deductions
- Estate tax

Passthroughs:
- New 20% deduction regime
- Losses limited
- Carried interest rule

Corporate:
- Rate reduction
- Expensing
- NOL limitation
- Interest limitation
- Contributions to capital

International:
- Participation exemption system
- Mandatory repatriation
- Minimum tax
- BEAT

H.R.1
(P.L. 115-97)

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What were the drivers of federal tax reform?

Improve the International Competitiveness of the US Corporate Income Tax System

Worldwide Taxation
Territorial Taxation

US Post-TCJA

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Personal income tax relief

- Rate relief
  - Reduces the top individual tax rate from 39.6% to 37%
  - Reduces other rates
  - Increases thresholds for alternative minimum tax ("AMT")
  - 20% deduction for owners of pass-through entities (e.g., partnerships, S corporations, sole proprietors)
    - Intended as offset to substantial C corporation rate reduction
Cost of rate relief? “Base expansion” (a/k/a “eliminate deductions”)

- Repeal personal exemptions
- Increase the standard deduction to $24,000 ($12,000 for married filing separately)
- Limit annual mortgage interest deduction to $750,000
- Limit annual aggregate deduction for State and Local Taxes to $10,000 ($5,000 for married individual filing separately)
  - Applies to all taxes – state income (including sales tax options) and property taxes
  - Exception for tax “on a trade or business” still retained
Corporate tax rate and corporate alternative minimum tax (AMT)

- 21% tax rate, effective 1/1/18 – 40% rate reduction
- Eliminates corporate AMT

Interest expense deduction

- Limits business interest deduction to 30% of adjusted taxable income (ATI) plus business interest income.
  - Initially, ATI computed without regard to depreciation, amortization, or depletion. Beginning in 2022, ATI is decreased by those items.
  - Limitation does not apply, at the taxpayer’s election, to any farming business or real property trade or business; regulated utilities generally excepted

Expensing

- Allows immediate write-off of qualified property placed in service after 9/27/17 and before 2023. Increased expensing phased-down starting in 2023. Taxpayers may elect to apply 50% expensing for the first tax year ending after 9/27/17.
- Eliminates original use requirement. Qualified property excludes certain public utility property and floor plan financing property.
Elements of the TCJA

**Net operating losses (NOLs)**
- Limits NOLs to 80% of taxable income for losses arising in tax years beginning after 2017
- Allows NOLs to be carried forward indefinitely (with interest)
- Repeals carryback provisions, except for certain farm and property and casualty insurance company losses

**Dividends received deduction (DRD)**
- Reduces the DRD from other than certain small businesses or those treated as “qualifying dividends” from 70% to 50%.
- Reduces dividends received from 20% owned corporations from 80% to 65%

**Section 179 expensing**
- Increases to $1 million for “qualified property” placed in service in tax years beginning after 2017, with a phase-out beginning at $2.5 million.
- Expands “qualified property” to include certain depreciable personal property used to furnish lodging, and improvements to nonresidential real property (e.g., roofs, heating, property protection systems)
International Tax Reform Elements of the TCJA

Transition Tax
- All post-1986 earnings and profits of controlled foreign corporations (CFCs) treated as special classification of Subpart F income of 10% US shareholders
- Reported on last return of the US shareholder for a year beginning on or before December 31, 2017 (i.e., for most corporate shareholders taxable at a rate of 35%)
- But … subject to a DEDUCTION that is equivalent to applying a 15.5% rate on E&P in cash or cash equivalents or 8% on E&P in all other types of assets.
- Payable over eight years (but reported on 2017 final return under pre-TCJA (Amended IRC §965)

Base erosion provisions (The Carrot and the Stick)
- The Stick - GILTI – Global Intangible Low Tax Income – essentially test every CFC for income on tangible investments … to the extent of excess compared to a 10% rate of return, include in the 10% US shareholders income (new IRC §951A (and deduction provided by new IRC §250)
- The Carrot – FDII – Foreign Derived Intangible Income – essentially provide a deduction for such income crating a reduced effective tax rate
- 37.5% deduction through 2025 (equivalent to 13.125% tax rate) then 21.875% deduction (equivalent to 16.4% tax rate)
Overall assessment - structural

- Greatest structural impact will be on individual side
  - Taxable income states because of proposal to double standard deduction and repeal personal exemption allowance – household size and distribution issues
  - Likely to be substantial distributional challenges given that child credit largely plays that role at the federal level
  - Conformity on itemized deductions – no revenue impact from repeal of state and local income tax deduction
  - Long-term approach to use of personal exemption allowances
  - Passthrough income deduction

- On the business side, there may be less here than meets the eye; issues will be complex but (mostly) of modest impact
  - Make decision on expensing
  - Coordinating interest disallowance with addbacks
  - Determining amount of repatriation and foreign inclusion and then resolving sourcing issues
  - Determining conformity to international base erosion provisions (GILTI) and if changes are necessary/desirable

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State Personal Income Tax: Starting Points

MAP LEGEND

- Federal Adjusted Gross Income
- Federal Taxable Income
- State Gross Income
- No Personal Income Tax

**VT:** Vermont state income tax calculations will begin at federal AGI rather than federal taxable income starting in tax year 2016.

Source: Federation of Tax Administrators as of January 2017
State Personal Income Tax: Conformity to Federal Tax Code

Source: Bloomberg BNA, IRC Conformity: Federation of Tax Administrators 2016 State Tax Collection by Source

*MA- Conforms the the IRC as of Jan. 1, 2015. However, for some provisions, Massachusetts conforms automatically to the Code for the taxable year.

*MS- Mississippi does not have a federal conformity law, but the IRC is incorporated by reference throughout the Mississippi tax code.
State Corporate Income Tax: Conformity to Federal Tax Code

MAP LEGEND

Rolling Conformity
Static Conformity
No Conformity
Does not Levy Corporate Income Tax

NV~Nevada levies a Modified Business Tax
OH~Ohio does not impose a corporate income tax, instead levies a Commercial Activities Tax.
OR~Oregon has a rolling conformity when related to taxable income, but for items other than taxable income, Oregon has a static IRC conformity.
TX~Texas levies a Margins Tax.
WA~Washington imposes a Business & Occupation Tax.

Source: Bloomberg BNA, IRC Conformity; Federation of Tax Administrators 2016 State Tax Collection by Source
New law will reduce federal revenues by $1.5 trillion over 10 years – as provided for in the budget resolution

- Deficit financing of cuts imposes fiscal constraints on the federal government and its ability to finance intergovernmental and other programs
- Stuff rolls down hill

Certain aspects of reform will constrain state tax resources

- Limit on deduction of state and local taxes
  - Increases the after-tax costs of state and local government at a time when federal resources will be constrained
  - Reducing federal rates has similar effect
Most state legislatures convene and adjourn within a few months during the first part of the year; a few states with no session in 2018
- Time for analysis is short with large number of uncertainties
- Time to develop comprehensive response and develop support necessary for passage is quite limited

Should not be unexpected that a number of states may take some precautionary/protective steps in 2018 legislative sessions and not reset conformity on some matters until later
As of January 3, 2018
UNRAVELLING FEDERAL TAX REFORM
Necessary Resources

- The *Tax Cuts and Jobs Act*
- Internal Revenue Code
- The State’s Code
- Joint Committee on Taxation Estimates
- Tax Forms
- IRS Statistics of Income
- Time and Patience

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The Joint Committee on Taxation produces estimates of the federal legislation. JCX-67-17 contains the estimates of the conference agreement for the Tax Cuts and Jobs Act.

- Lists each revenue provision
- Groups the provisions by type
Use the Tax Forms

- Tax forms summarize hundreds of pages of tax law into about a dozen pages
Identify the Provisions

- Provisions that make changes above-the-line that will flow through to the state’s tax base
- State deductions, exemptions, and credits linked to federal provisions
- Shared definitions for other programs
Estimate the Revenue Impact

☐ For Flow Through Provisions -
  - Use the Joint Committee on Taxation’s estimates as the basis
    - Determine the associated federal tax base
    - Estimate the state’s share of the associated federal tax base
    - Apply the state’s tax rate
    - Adjust for timing

☐ For Linked Provisions -
  - Use the state’s own data to provide estimates
Links

- **Tax Cut and Jobs Act**

- **Joint Committee on Taxation**
  - [https://www.jct.gov/](https://www.jct.gov/)

- **IRS Tax Statistics**
Examples of complexity of state conformity to the TCJA
20% deduction for PTE owners

- **NEW** IRC §199A Deduction for Qualified Business Income (TCJA §11011)

- 20% individual owner deduction for income received from PTE:
  - PTE – Sole proprietorship, partnerships, S corporations:
    - Also includes income from limited liability companies (LLCs):
      - Treated as disregarded entities from individual owners, partnerships or electing as S corporations
    - Dividends received from cooperatives, real estate investment trusts (REITs) and publicly traded partnerships (PTPs) also qualify
  - Intended to provide an equalized federal rate reduction for PTE owners compared to owners of a C corporation:
    - 20% deduction (for 37% taxpayer) = 29.6% federal tax rate
“Qualified business income” of a PTE:

- Cross references to unusual and unrelated sections of the IRC

“Qualified trade or business:”

- “Effectively connected with a trade or business within the US” – IRC §864(c) (an international tax provision)

“Specified service trade or business” income ineligible:

- Citing to IRC §1202(e)(3)(A) – small business stock capital gain exception
- With a limited exception, no deduction for income from:
  - Law, accounting, medicine, professional sports
  - But – at last minute – Congress inserted deduction for “engineering” and “architectural” income in TCJA
- Performing services as an employee
“Qualified trade or business:”
- Special “exception to the exception” for owners of disqualified service businesses with income below $415,000 (married filing jointly) – “Threshold amount:”
  - Could end up with partners in the same partnership subject to widely varying tax rates

- A lot of other complex provisions
- The key – 20% federal deduction from individual income
Most states automatically won’t follow this provision because of another provision of the TCJA probably not intended by Congress ... (or someone was really, really clever):

- TCJA §11011(b) sets forth how the 20% PTE deduction is applied for federal income tax purposes:
  - Subsec. 1 - Not deductible under IRC §62(a) – what does that mean?
    - Defines “Adjusted Gross Income” (AGI)
  - Subsec. 2 - Deductible under IRC §63(b) – what does that mean?
    - Defines “Taxable Income” (TI)

- By allowing deduction under TI (instead of AGI) allows non-itemizers to claim deduction:
  - Only fisherman and shippers had that advantage before
Accordiing to the Federation of Tax Administrators*: 

- Most states use “adjusted gross income” as the starting point for determining their state personal income tax base.
- Only seven states use “taxable income”:
  - Colorado
  - Idaho
  - Minnesota
  - North Dakota
  - Oregon
  - South Carolina
  - Vermont

- Except for these seven, unless the state legislature expressly chooses to conform, the 20% deduction for PTE owners won’t apply for state tax purposes:
  - Expect a state “addback”.

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TCJA limits state and local tax deduction for individuals to $10,000 annually ($5,000 married filing separately) (amended IRC §164)

- House version completely eliminated it
- Part of federal income tax law since 1913
  - U.S. Supreme Court rejected “Intergovernmental immunity” doctrine (i.e., federal government can’t tax states) in *South Carolina v. Baker*, 485 U.S. 505 (1988)
- Still available for taxes “on a trade or business”
  - Corporation still entitled to deductions
  - PTE’s but not for income tax
  - Conference Committee report makes clear that business owner income taxes are NOT “on a trade or business” (FN. 168 (citing to 1944 Congressional report for Individual Income Tax Act of 1944))
State and local tax deduction

- Direct revenue impact on states?
  - None (most state income tax laws (individual and corporate) always added it back – for different policy reasons)

- Political impact?
  - (Not ours to discuss)

- Recent responses?
  - NY Gov. Cuomo – “deductible payroll tax”
  - CA legislators – “charitable entities” for government services
  - IRS ruling on prepaid property tax (not allowed unless assessed)
Questions?

Please type your questions into the text box located in the bottom left-hand corner of the screen.
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NCSL Resources and Contacts

NCSL Webpage: Federal Tax Reform and the States

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Jan. 12, 2018
Max Behlke

Max Behlke is the Director of Budget and Tax in the National Conference of State Legislatures’ Washington D.C. office. In his role, he coordinates the conference’s advocacy before congress and the administration in the areas of budgeting, taxation, unfunded mandates, and fiscal federalism. He has a particular focus in the field of taxation of digital and interstate commerce, which is one of the primary state-federal issue areas for NCSL and the states.

Mr. Behlke also serves as Director of the NCSL Executive Committee Task Force on State and Local Taxation, which meets four times each year to consider the most pressing issues for state’s in the tax policy arena. Under his direction, the task force has grown to become one of the most influential voices in the field of state tax. In 2016, the Task Force was named as “Tax Organization of the Year” by State Tax Notes. His expertise has been cited in publications that include the New York Times, the Wall Street Journal, USA Today, the Washington Post, the Los Angeles Times, the Baltimore Sun, the Christian Science Monitor, CNN, NPR, ABC News, Bloomberg, CNBC, Fox, Forbes, Governing, Stateline, Reuters, and the Associated Press.

Prior to joining NCSL in 2010, Max worked in the Maryland Legislature. He holds a Bachelor of Arts in Government and Politics from the University of Maryland, College Park and a Master in Public Administration degree from the University of North Carolina, Chapel Hill.
Mr. Duncan currently serves as the State and Local Tax (SALT) leader for Washington National Tax (WNT). Aside from his role as WNT-SALT leader, his primary responsibilities at KPMG include improving relationships with state taxing authorities, assisting clients in working with state tax agencies, keeping clients and firm members abreast of current developments and aiding the firm’s resource network. He specializes in assisting clients to resolve controversies with state tax agencies.

**Professional and industry experience:** Prior to moving to KPMG in July 2008, Mr. Duncan spent the previous 20 years as Executive Director of the Federation of Tax Administrators, the association representing the principal state revenue collection agencies in each of the 50 states, D.C., and New York City. He also served five years as Secretary of the Kansas Department of Revenue. Prior to that, he was the Assistant Director of the Kansas Division of the Budget. He has held positions with South Dakota state government, the Advisory Commission on Intergovernmental Relations and the National Governors' Association. Mr. Duncan received New York University’s Outstanding Achievement in State and Local Taxation Award in December 2006 and was awarded the IRS Commissioner’s Award in June 2008. He was cited as “The Most Influential Person on the Planet in State and Local Tax” by State Tax Notes in 2008.

**Publications and speaking engagements:** Mr. Duncan is the author and co-author of a number of articles and papers on state and local taxation and public budgeting. He has recently published several articles on VAT and the coordination of a VAT with state and local sales taxes. His most recent work includes a paper developed for the American Tax Policy Institute on “Administrative Issues from the Adoption of a Federal VAT in Addition to Existing Federal and State Taxes” and a study entitled “Administration of State and Local Taxes on the Sale and Distribution of Beer” for the National Beer Wholesalers Association. He is also a frequent speaker at state and local tax conferences and meetings.
Heath Holloway is a Deputy Director of the Office of Fiscal and Management Analysis with the Indiana Legislative Services Agency. His primary subject matter areas are economic development, business association law, and state and local taxes. He is an advisor to the Indiana Revenue Forecast Technical Committee and a member of the tax incentive evaluation team.

Before going to the Indiana General Assembly in 2012, Heath worked for the State of New York at the Higher Education Services Corporation and Department of Taxation and Finance for over eight years. He received a Master of Public and Environmental Affairs and Bachelor’s degree from Indiana-Purdue University Fort Wayne, Indiana.
Steve Wlodychak

Steve is a principal in Ernst & Young LLP’s National Tax Department in Washington, DC and the state and local leader of its Center for Tax Policy where he monitors state and local tax developments throughout the US. In addition, Steve is a leading principal in its state and local transactions tax practice, focusing on assisting private equity and strategic investors in the structuring and due diligence investigations of numerous transactions. He has addressed state and local tax considerations of transactions in all 50 states and on more than 900 different transactions.

Steve previously served in Ernst & Young LLP’s Los Angeles and New York offices, was a state and local tax attorney for one of America's largest insurance companies, and an associate attorney with a major regional law firm. He previously worked in state government in New Jersey, including for the governor of the state.

Steve has published extensively on various aspects of state and local taxation, most recently as the co-author of Bloomberg BNA's *Pass-through Entity Tax Navigator*, an electronically based resource that provides coverage of the state taxation of partnerships, S corporations and other pass-through entities. A frequent speaker, Steve hosts the EY’s popular quarterly State and Local Tax webcasts and has led seminars on state and local tax matters throughout the US on a wide range of state and local tax topics.

Steve is a graduate of Georgetown University’s School of Foreign Service, received his law degree from Seton Hall University’s School of Law (where he also served as an Associate Editor of the Law Review) and received his LLM in Taxation from New York University.

Steve is a guest lecturer on state and local taxation at Georgetown University’s School of Law and a member of the bar associations of the District of Columbia, New Jersey and New York.