State Implications of Federal Tax Reform

National Conference of State Legislatures

Midwest States Fiscal Leaders Meeting

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Notices

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Overview

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) would affect state taxes if the state adopts the change
  - Most changes in tax credits would 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 would 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

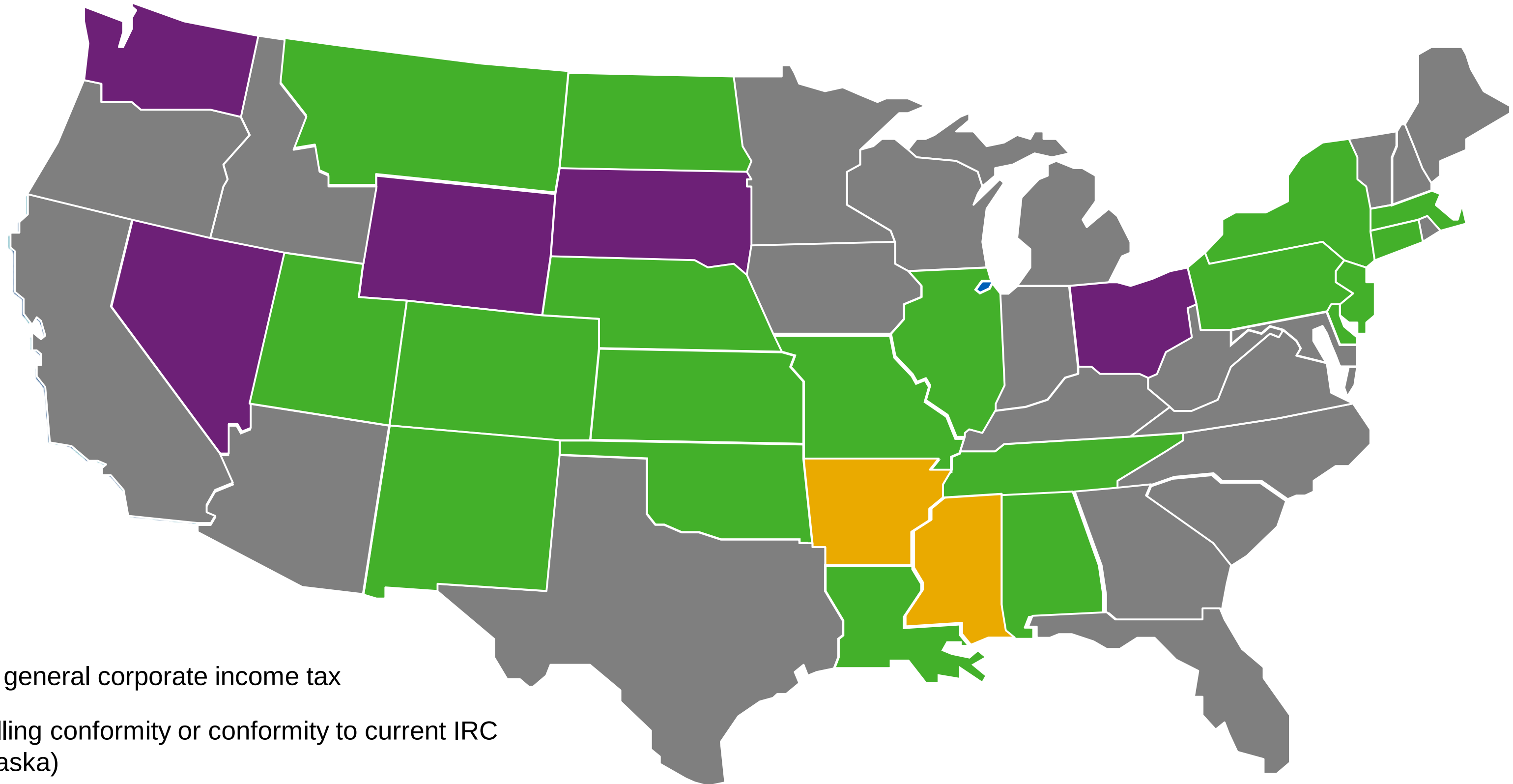
How do states conform to the Internal Revenue Code?

- “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

At individual level, most states begin with AGI and conform to itemized deduction definitions; establish their own personal exemption allowances and standard deduction

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

Key State Tax and Fiscal Impacts

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

H.R.1

Corporate:

Rate reduction

Expensing

NOL limitation

Interest limitation

Contributions to capital

International:

Participation exemption system

Mandatory repatriation

Minimum tax

BEAT

Marquee items for states - Individual

Double standard deduction, repeal personal exemptions, expand child credit

— Most significant impact on seven taxable income states and five others that use the federal amount for state standard deduction

— Indirect impact on other states that use personal exemptions

- Since beginning of the income tax has been the primary adjustment mechanism for family size
- Potential compliance issues with state exemptions and no federal "check"

— Most states do not currently utilize a child credit for progressivity or family size

Revamp of itemized deductions

— Repeal/suspension of most itemized deductions except mortgage interest and charitable contributions

— Limit deduction of state and local taxes except for $10,000 property or income taxes per return

— Direct impact on deductions/base in most states with noticeable revenue impact

Provisions expire as of December 31, 2025

Marquee items for states - Business

100 percent bonus depreciation for five years (and expanded 179)

— Expanded range of assets allowed bonus

— Primary issue is for states that currently conform to the 50 percent regime

Deduction for certain passthrough income

— Current issue for most rolling conformity states

— Deduction will not affect AGI, but will be allowed as an ‘itemized’ deduction that is allowed to taxpayers who itemize and those who do not

— Substantial revenue impact; $400 billion impact at federal level

Limitation on interest deductions

— Capped at 30 percent of Alternative Taxable Income

— Would broaden state tax base; impact increases after three years

— Complexity in determining allocation among state taxpayers and coordinating with current state interest addback provisions

Other – NOLs, various deduction tightening, contributions to capital

Marquee items for states - International

Move toward a territorial system

- Repeal of current deferral system and allow 100 percent elimination of future foreign dividends
- States could choose to not conform
- States currently allow substantial deduction for dividends –both foreign and domestic

Mandatory repatriation of previously deferred income

- States currently allow substantial deduction for subpart F income and/or foreign dividends/income
- Some substantial complexity in determining amount to be included in state income
- Modest impact, but volume of repatriated amounts is large
- Does state incorporate the “participation exemption”

Minimum tax on global intangible low taxed income (GILTI)

- Could expand base in some states
- More complexity in determining the amount to be included in state income
- Does the state incorporate the Sec. 250 deduction
- Similar issue with foreign-derived intangible income (FDII)

Base erosion anti-abuse tax (BEAT)

- Additional tax on inbound transactions
- No likely impact

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

Overall assessment - fiscal

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

Timing is delicate and important

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

State Reactions to Federal Tax Reform

Reactions by governors and legislatures

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
- States are beginning to release preliminary estimates of the impact to state budgets from federal tax reform
- A few states using federal tax reform as a platform to support state tax reform
- More states are proposing independent state tax reform

States Proposing Workaround to SALT Deduction Cap

State	Charitable contribution funds	Payroll tax system	Pass through entity tax
California	Yes	N/A	N/A
Connecticut	Yes	Yes	Yes
Illinois	Yes	N/A	N/A
Maryland	Yes	N/A	N/A
Nebraska	Yes	N/A	N/A
New Jersey	Yes	N/A	N/A
New York	Yes	Yes	N/A
Oregon	Yes	N/A	N/A
Virginia	Yes	N/A	N/A
Washington	Yes (for sales tax)	N/A	N/A

State reactions – Cont'd.

Surprising Comments or Lack of Reactions

- A number of states have not officially commented on the impact to state taxes from federal tax reform
- Well over half of Governors did not address federal tax reform in their State of State addresses
- Antagonistic nature of comments by the U.S. Secretary of Treasury regarding proposed workarounds to SALT deduction cap
- Noticeably absent are comments related to corporate income tax, including mandatory repatriation and GILTI income
- Governors of four Northeast states (Connecticut, Maryland, New Jersey, and New York) plan to sue the federal government over the new federal tax law
- Limited analysis on the 20 percent deduction for qualified business income from a partnership
- Only ten states have proposed conformity legislation to date

State reactions – Cont'd.

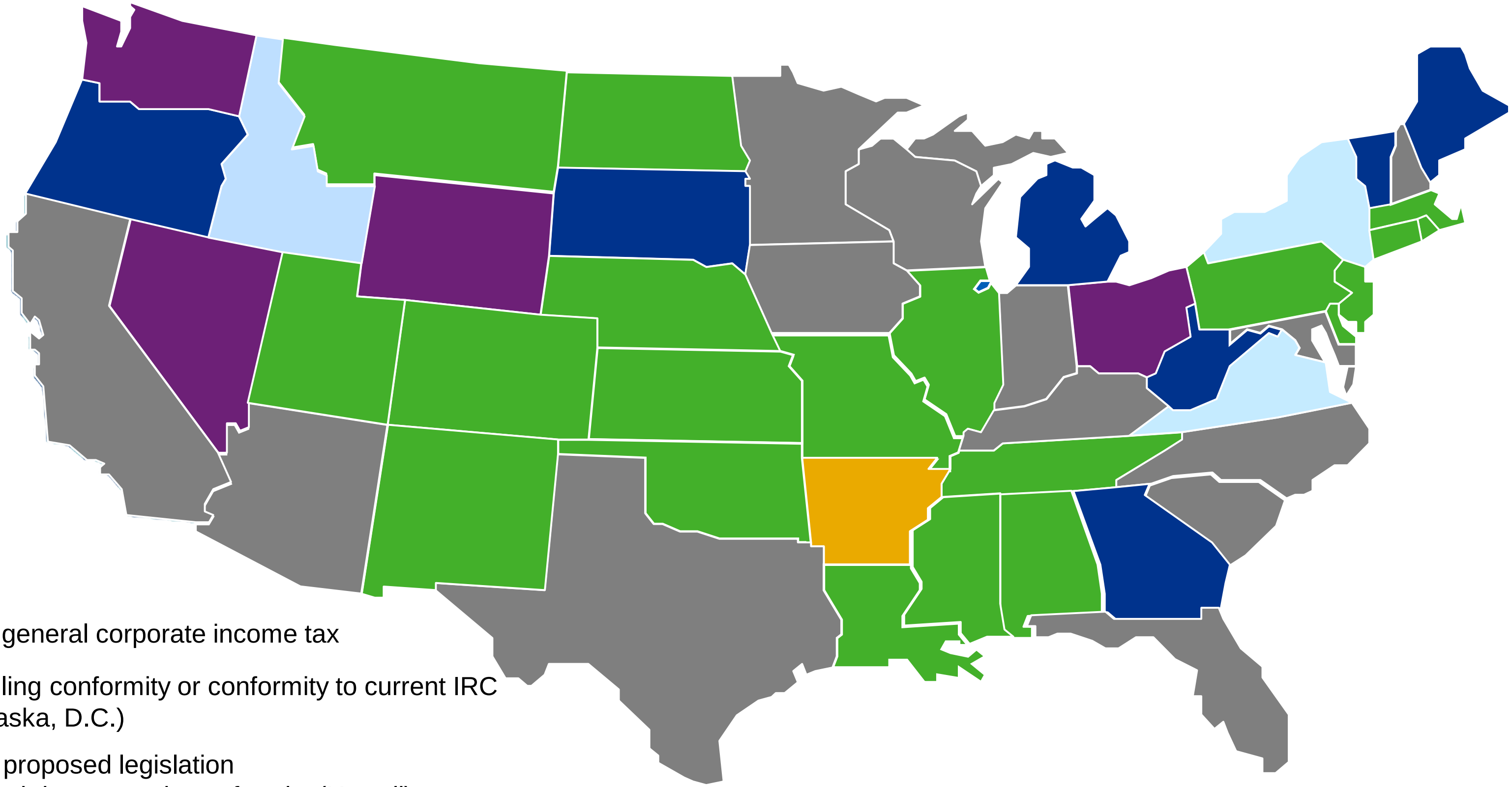
States Proposing Tax Reform in Response to Federal Tax Reform		States Proposing Independent State Tax Reform
Connecticut	New York (voluntary employer-based payroll tax)	Missouri
Georgia	Oregon (DRD to apply against amounts that are repatriated)	Nebraska
Hawaii (adopts 20 percent deduction for QBI)	Pennsylvania (decouple from federal bonus depreciation)	New Mexico
Idaho	Tennessee (recouple to federal bonus depreciation)	South Carolina
Iowa	Vermont	West Virginia
Maryland		

States that have Proposed Conformity Legislation	
Pre Federal Tax Reform	**Post Federal Tax Reform**
Idaho (enacted)	Georgia
New York	Maine
Virginia	Michigan (or at the option of the taxpayer, in effect for the tax year)
	Oregon
	South Dakota
	Vermont
	West Virginia (will become law on 02/15/18)

State reactions – Cont'd.

- D.C.: HB 639 requires the DC CFO to submit a report outlining the steps and amendments necessary to decouple the District's tax deduction laws from federal law no later than April 30, 2018.
- Georgia: HB 821 updates the IRC for tax years beginning on or after 1/1/17 to mean the IRC as of 1/1/18 except for certain enumerated sections; Adopts 80 percent NOL limitation; Provides that IRC section 118 (applies pre-tax reform) and addresses repatriation and GILTI.
  - It appears the bill makes clear that GILTI is not treated as a foreign dividend and that deduction provided in IRC section 250 applies. The bill also attempts to ensure there is no "double-dipping" and disallows deductions allowed under IRC section 965.
- Idaho (enacted): HB 355 requires an addback for amounts deducted for federal purposes under IRC section 965 and other special deductions; Updates the IRC to mean for taxable years beginning on or after the first day of January 2017, the Internal Revenue Code of 1986 of the United States, as amended, and in effect on the 21st day of December 2018, *except that IRC sections 965 and 213 are applied as in effect on December 31, 2017.*
- Michigan: HB 5420 changes the definition of internal revenue code and defines it as the United States internal revenue code of 1986 in effect on January 1, 2018 or at the option of the taxpayer, in effect for the tax year.
- Oregon: SB 1529 updates the definition of internal revenue code to mean the federal Internal Revenue Code, as amended and in effect on December 31, 2017. SB 1529 would require an addback for amounts deducted for income repatriated, deemed or otherwise, under section 965 of the Internal Revenue Code and adopts a tax haven tax credit to recognize the interaction between tax payments required by Oregon's tax haven law and repatriation related tax payments.

Proposed IRC conformity legislation



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Legislation proposed conforming to IRC as of date that is pre tax reform

Legislation proposed conforming to IRC as of date that is post tax reform

State reactions – Cont’d.

State	Expected Decrease or Increase in Revenue from Federal Tax Reform	20 Percent QBI Deduction
Arizona	Increase	No analysis of state impact from 20 percent deduction for QBI
California	No Analysis	No analysis of state impact from 20 percent deduction for QBI
Colorado	Increase	No analysis of state impact from 20 percent deduction for QBI
Idaho	Decrease	The Idaho State Tax Commission estimates a reduction in pass through income by 20 percent on the owner's income tax return and a reduction in Idaho revenue by approximately $31 million
Louisiana	Increase	No analysis of state impact from 20 percent deduction for QBI
Maine	Increase	The deduction is not linked to Maine's tax provisions
Maryland	Increase	The Board of Revenue Estimates quantifies the magnitude of income involved in the impact of the 20 percent deduction based on the 2014 tax year

State reactions – Cont’d.

State	Expected Decrease or Increase in Revenue from Federal Tax Reform	20 Percent QBI Deduction
Michigan	Increase	No analysis of state impact from 20 percent deduction for QBI
Minnesota	Increase	Conforming to the deduction will reduce projected revenues by $18 million in FY 2018, increasing to $302 million in FY 2021
New York	Increase	The Department of Taxation and Finance outlined options to offset the revenue loss from the 20 percent deduction including imposing a tax on the net income of pass through entities, similar to the NYC UBT, or imposing a tax on the gross receipts of pass-through entities, similar to filing fees paid by LLCs
North Carolina	No significant impact	No estimated impact
North Dakota	Increase	No analysis of state impact from 20 percent deduction for QBI
Oregon	Increase	The Legislative Revenue Office estimates a decrease in revenue of $182 million in 2018 to $277 million in 2025
South Carolina	Increase	The Revenue and Fiscal Affairs Offices estimates a decrease of $93 million from the QBI deduction in Fiscal Year 2018-2019
Vermont	Increase	No estimated impact because changes should not flow through to Vermont because there is no allowance for the pass through deduction outlined in Vermont statutes

Q&A

Thank you

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Thank you

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