State Implications of Federal Tax Reform

National Conference of State Legislatures

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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

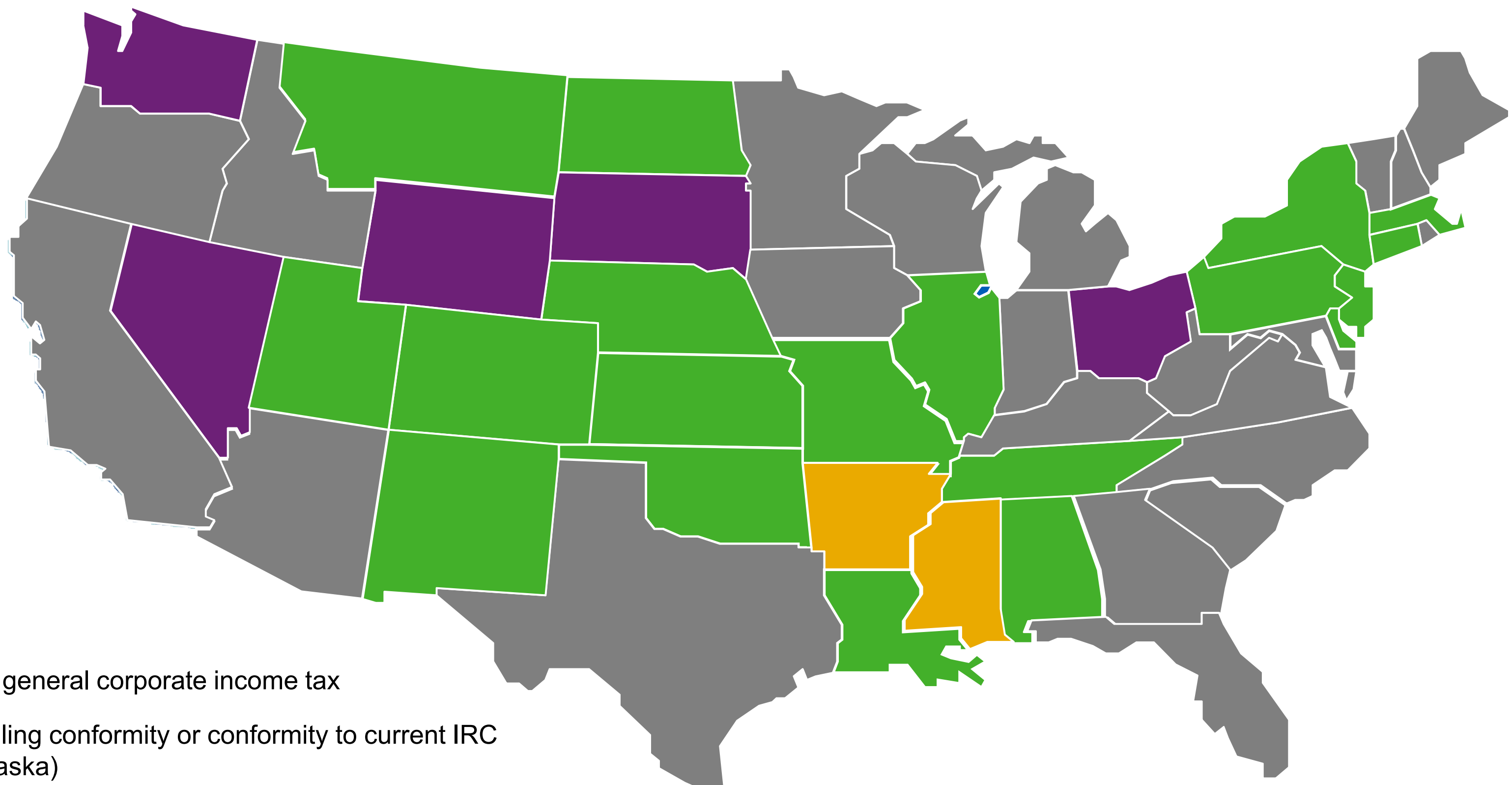
How do states conform to the Internal Revenue Code?

- "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

Rate restructuring

— No direct impact

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, but modest revenue impact

Provisions expire as of December 31, 2025

Marquee items for states - Business

Reduce rate to 21 percent

— No direct impact

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

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

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

What to expect from states?

First order of priority likely to be individual income tax

— Dealing with substantial changes in standard deduction, personal exemptions and itemized deductions

— Dealing with the limitation on deduction for state and local taxes and passthrough deduction

— Business tax issues, other than expensing, may wait

Prospects for state reductions in rates is unclear (at best)

— Any state base broadening likely to be relatively less than at federal level because of lack of conformity and other issues

— State fiscal conditions may not allow for it, and deficit financing not allowed

— Limited pressure for state reductions in pass-through rates unless they also reduce regular corporate rate

— States likely have independent reform goals

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Thank you

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