Don't Forget the SALT: State and Local Tax Implications of Federal Tax Reform

By Harley Duncan, Dan De Jong, Marianne Evans, and Sarah McGahan

2018 is a new year and with it comes new challenges and opportunities for U.S. taxpayers. On December 22, 2017, President Trump signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act." This sweeping federal tax reform bill significantly affects the computation of federal taxable income and revises how multinational business are taxed. And, while federal taxpayers and practitioners now simply must digest the federal changes, their state counterparts are further challenged. For state purposes, it is necessary to understand the federal changes and how they currently apply in each state, while at the same time understanding that there will be much legislative activity this year as states respond to the new federal laws.

General background

Nearly every state corporate and personal income tax conforms in some manner to the federal Code. Conformity between state and federal taxes simplifies compliance for taxpayers, and at the same time, reduces the administrative burden facing state tax authorities.

States follow two patterns in conforming to the federal income tax. Rolling or current conformity states tie the state tax to the Code for the tax year in question, meaning they adopt all changes to the Code as passed by Congress unless the state passes legislation to decouple from specific provisions. Static or fixed-date conformity states tie to the Code as of a particular date (e.g., December 31, 2016), meaning the state legislature must act to incorporate subsequent federal changes into the state tax code. States are about evenly divided between rolling and static conformity. A small number of states, notably California, adopt selected Code provisions, rather than using the blanket approach used by most states. Static conformity states generally update their conformity annually or at least regularly; California tends to be an exception and is somewhat irregular in its conformity updates for various reasons.

Corporate overview

For corporate income taxes, states generally begin the computation of state corporate taxable income with federal taxable income and therefore allow, for state tax purposes, many federal deductions. A majority of the states start with line 28 of federal Form 1120 (taxable income before net operating losses and special deductions), and most of the remaining states start with line 30, which includes net operating losses and special deductions. States establish their own tax rates and do not, for the most part, conform to various federal tax credits aimed at promoting various types of activities, such as credits for alternative energy sources. The research and development credit is an exception, as a number of states allow a counterpart credit based largely on the contours of the federal credit.

Regardless of whether they use rolling or static conformity, states tend to pick and choose the federal items to which they will conform, often choosing not to conform to items that have major revenue loss consequences. For example, many states have historically decoupled from federal bonus depreciation.

Individual overview

On the individual income tax side, most states conform to the federal definition of adjusted gross income (AGI). Seven states conform to federal taxable income (meaning they incorporate the federal standard deduction and the currently-suspended personal exemption allowance in addition to the AGI provisions). States that allow itemized deductions also usually conform to federal itemized deductions, with the most common model allowing all federal itemized deductions other than the deduction for state income taxes. There are 11 states that do not provide for itemized deductions.

As with the corporate tax, states establish their own tax rates and tend not to conform to a wide range of federal income tax credits. The earned income credit is the most common exception to this general rule. In addition, only a few states have an individual AMT.

Given these relationships between federal and state income taxes, enactment of federal tax changes that affect the computation of the tax base, by altering the income reflected or the deductions allowed, will have an impact on state taxes. Changes to federal tax rates and tax credits will not, for the most part, have a direct impact on state taxes. With this as background, the state tax implications of certain of the changes contained in H.R. 1 are reviewed in more detail below.

Individual provisions

— **Tax rates:** H.R. 1 retains seven individual income tax rate brackets with a maximum rate of 37%, compared to the 39.6% former highest rate. The maximum is applicable at $500,000 taxable income for single filers and $600,000 for those filing joint returns. *These rates and most of the individual income tax provisions in H.R. 1 expire after December 31, 2025. At that point, the law reverts to the law as in effect before January 1, 2018.* The revision of tax rates and brackets proposed in H.R. 1 will not directly affect state taxes as states establish their own individual tax rate structures.

— **Passthrough deduction:** H.R. 1 allows an individual taxpayer to deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship. This deduction, similar to the other provisions affecting individual taxpayers, sunsets after 2025. The deduction generally is limited to the greater of: (a) 50% of the W-2 wages paid with respect to the trade or business; or (b) 25% of the W-2 wages paid with respect to the trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property. The limitation described in the preceding sentence does not apply in the case of a taxpayer with income of $315,000 or less for married individuals filing jointly ($157,500 for other individuals), with a phase-in over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals). Qualified income is defined generally to include income arising from the conduct of a trade or business, other than specified service trades or businesses (e.g. health, law, accounting, but specifically excluding engineering and architecture). There is an exception allowing the 20% deduction in the case of certain taxpayers with income from a specified service business whose taxable income does not exceed $315,000 for married individuals filing jointly or $157,500 for other individuals with a phase-out of this benefit over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

The passthrough deduction is structured as a new Code section 199A. H.R. 1 specifies that the deduction is not be taken into account in computing AGI for individual income tax purposes. Instead, it is treated as an itemized deduction from taxable income. However, the deduction is available both to taxpayers that itemize their deductions and those that do not. As such, the impact at the state level will depend on the manner in which a state conforms to itemized deductions. As noted, most states currently conform to federal itemized deductions with the exception of the deduction for state income taxes paid. There are 11 states that do not allow itemized deductions. The impact of the passthrough deduction on states could be substantial. The Joint Committee on Taxation estimates that the federal revenue impact of the provision is about $415 billion over the eight years it is in place.

— **Standard deduction, personal exemption allowance, and child credit:** H.R. 1 effectively doubles the standard deduction for all tax filers, repeals the personal exemption allowances, and enhances the child tax credit. These changes are all temporary and are scheduled to sunset at the end of 2025. These changes will not automatically affect most state personal income taxes as the large majority of states with an individual income tax conform to AGI, which is computed before these factors come into play. There are, however, seven states that conform to the federal definition of taxable income for individual income tax purposes, meaning the changes in the standard deduction and suspension of personal exemptions will be incorporated into the state individual income tax, presuming continued conformity. There are five additional states that have adopted the federal standard deduction levels under current law. There are ten states that do not utilize a standard deduction in their personal income tax.

— **Itemized deductions:** H.R. 1 temporarily repeals or revises many federal itemized deductions, including deductions for state and local property, income and sales taxes, personal casualty losses, mortgage interest, and a variety of miscellaneous deductions. Specifically, the changes to itemized deductions contained in H.R. 1, all of which apply to tax years beginning after December 31, 2017 and before January 1, 2026 unless otherwise noted, include:

  – The deduction for mortgage interest is limited to the interest on $750,000 of acquisition indebtedness for debt incurred after December 15, 2017. The limit on deducting interest on acquisition indebtedness for debt incurred prior to December 15, 2017 remains at $1,000,000. H.R. 1 repeals the deduction related to interest incurred on home equity debt.

  – In the case of an individual, H.R. 1 limits the deduction for state, local and foreign property taxes and state and local sales taxes, as a general matter, only to such taxes when they are paid or accrued in carrying on a trade or business. State and local income taxes, war profits taxes and excess profits taxes are not allowed as a deduction for an individual taxpayer. H.R. 1 contains an exception to this general rule allowing an individual taxpayer to claim an itemized deduction of up to $10,000 (in the aggregate) for state and local property taxes not incurred in carrying on a trade or business and state and local income, war profits and excess profits taxes (or sales taxes in lieu of income taxes). Foreign real property taxes are not deductible under the exception.

  – The personal casualty loss deduction is retained in H.R. 1, but only for losses incurred in a federally declared disaster area.

  – H.R. 1 provides an itemized deduction for unreimbursed medical expenses in excess of 7.5% of AGI for tax years 2017 and 2018.

  – Miscellaneous itemized deductions subject to the 2% of AGI floor (e.g., tax preparation expenses, work clothing, hobby expenses, and unreimbursed business expenses) are repealed under H.R. 1.

  – H.R. 1 also repeals the overall limitation on itemized deductions.

  With respect to the deduction of state and local income, property, and sales taxes, the explanatory statement makes clear that, in the case of an individual, the state and local income taxes imposed on individual owners or partners in the passthrough entity are not deductible. However, state and local income taxes imposed at the entity level that are reflected in computing the owner's or partner's distributive share of income from the passthrough remain deductible. Also, property taxes and sales and use taxes paid by the passthrough entity remain deductible.

  As noted, the large majority of individual income tax states that allow itemized deductions conform to the federal definitions of those deductions, meaning that most of the changes will affect those states. Importantly, however, the largest component of the revenue effect of the itemized deductions appears to be from the repeal of the state and local tax income deduction, which is not allowed in the vast majority of states that allow itemized deductions. Property taxes are, however, generally allowed as a state itemized deduction. To the extent a state retains itemized deductions not allowed at the federal level, there could be challenges in documentation and compliance.

— **Repeal of the so-called "individual mandate":** Under H.R. 1, the amount of the individual shared responsibility payment enacted as part of the Affordable Care Act is reduced to zero. Repeal of the individual mandate will not directly affect an individual's state tax liability.

— **Alternative minimum tax:** H.R. 1 retains the individual AMT with an increased exemption amount for tax years 2018 through 2025. Beginning in tax year 2026, the exemption amount would revert to the pre-reform level. A few states impose an AMT. State alternative minimum taxes are generally modeled after the federal tax, but they are not computed as a percentage of federal AMT liability. Therefore, the retention of the federal AMT should have little to no effect for state purposes.

Business provisions

- **Tax rates:** H.R. 1 reduces the corporate income tax rate to 21% beginning in 2018. This change does not directly impact state rates as states establish their own rate structures. The reduction in the federal rate may cause state corporate income taxes to be relatively more important versus the federal tax, and consequently, may increase the attention paid to state tax rates if they remain unchanged. Due to the lower federal rate, the federal 80% dividends received deduction is reduced to 65% and the federal 70% dividends received deduction is reduced to 50%. These federal changes may affect the state tax base in those states that conform to the federal dividends-received deduction amounts.

- **Expensing certain assets:** H.R. 1 increases 50% bonus depreciation regime under Code section 168(k) to 100% expensing for qualified assets placed in service after September 27, 2017 and before December 31, 2022. For assets placed in service after that date, the amount of expensing allowed declines by 20 percentage points each year, until it phases out for property placed in service after December 31, 2026. In terms of property qualifying for the 100% expensing, H.R. 1 continues to apply the expensing to most assets that were previously covered by bonus depreciation and expands that coverage to include used assets that are acquired by a taxpayer for the first time. The expensing provisions will not apply to certain property of regulated utilities or to property financed by floor financing indebtedness. H.R. 1 also increases the availability of expensing for certain small businesses under Code section 179. The increased 100 percent expensing allowance will flow through to the state tax base in a rolling conformity state unless the state acts to decouple or has already decoupled from bonus depreciation. There will be no impact in a static conformity state unless the state acts to adopt the change.

  About 30 states have chosen not to conform to the federal bonus depreciation regime, largely because of the negative revenue impact. The revenue implications of the new 100% expensing provisions and the enhanced deductions allowed during the phase-out will be substantial both for states that conform to bonus depreciation and those that do not conform. In other words, certain states that conformed to the prior 50% bonus depreciation may not be able to absorb the cost of the new immediate expensing provisions. Because the full expensing system is accomplished by amending Code section 168(k), there are likely to be a minimum of compliance-related issues emanating from the change beyond those experienced currently in states that do not conform to bonus depreciation.

- **Interest deductibility:** H.R. 1 disallows the deduction of net interest expense (excluding floor plan financing interest) to the extent it exceeds 30% of a taxpayer's adjusted taxable income (ATI), with an exception for taxpayers with an average of $25 million or less in gross receipts over the three prior years, certain real property businesses, farming businesses, regulated public utilities, and electric cooperatives. Unused amounts can be carried forward indefinitely. ATI is defined as the taxable income of the taxpayer computed without regard to any business interest or business interest income, the 20% deduction for certain passthrough entities, NOLs, and for tax years beginning before January 1, 2022, any deduction for depreciation, amortization or depletion.

  This limitation may flow through to the state tax base. At the federal level, the limit on interest deductibility is generally viewed as a counterpart to the 100% expensing allowed for certain assets (even though it is a permanent change and the 100% expensing starts to phase out after five years). Whether that policy carries over to states is an open question. The Joint Committee on Taxation estimates that the federal revenue impact of the interest limitation is $250 billion over 10 years.

  If a state chooses to conform to the interest limitation, there will be certain complexities because of the different filing methods at the state and federal level. The federal limitation appears to be determined at the taxpayer level, which would, in many cases, be the consolidated group. For state purposes, a member of the federal consolidated group may be required to file a separate state return or as a member of a unitary combined group. To deal with the different composition of the "taxpayer" at the state level, states often require individual consolidated group members to re-compute federal taxable income as if the member had filed separately, rather than consolidated, at the federal level. In addition, over 20 states currently have rules that disallow the deduction of interest or intangible-related interest paid to related parties. Coordinating the state and federal rules in these states could also present complications. For example, because the federal limit applies to all interest, and money is fungible, it may not be clear whether the character of the interest that is allowed to be deducted is "related party" interest for state purposes.

- **Net operating loss limitations:** H.R. 1 restricts the use of net operating losses (NOLs) by taxpayers (other than property and casualty insurance companies). Effective for losses arising in tax years beginning after December 31, 2017, the NOL carryback provisions are repealed in most cases, NOLs are allowed to be carried forward indefinitely, and the NOL deduction is limited to 80% of the taxpayer's taxable income determined without regard to the deduction. Many states start their computation of state taxable income with Line 28 of the federal form 1120, which is federal taxable income before NOLs and special deductions. Other states that start the computation of taxable income with Line 30 require an addback of the federal NOL and then require computation of a state specific NOL. There are only a handful of states that directly incorporate the federal NOL. However, a number of states reference IRC section 172 in the statutes providing for the state-specific NOL (e.g., stating that the state NOL should be treated in the same manner as for federal purposes). Because the new 80% federal NOL limitation is added to IRC section 172, it is unclear how that limitation will interact with those state NOL provisions that reference section 172. States also vary significantly in their allowance of NOL carryforwards and carrybacks. Most states do not allow a carryback, and there are varying (but always specified) carryforward periods. In addition, several states have their own limitations (e.g., Louisiana and Pennsylvania) on the extent to which NOLs may offset taxable income. States seem likely to continue to choose their own approach to NOLs, resulting in continued complexity.
- **Repeal of other deductions and modification of certain credits:** H.R. 1 repeals and limits certain other business deductions (e.g., certain meals and entertainment expenses, transportation fringe benefits, and expenses for lobbying before local governments). To the extent a state currently conforms to a deduction, limiting or repealing the deduction broadens the state tax base (assuming continued conformity). One of the most significant deductions repealed is the section 199 deduction (effective for tax years beginning after December 31, 2017 for C corporations) to which about one-half of the states currently conform. Interestingly, in a fixed-date state that currently allows the section 199 deduction, there would appear to continue to be a state-only section 199 deduction until the state updates its IRC conformity. H.R. 1 modifies some existing corporation tax credits, but the modifications will not have a significant impact on state taxes.
- **Contributions to capital:** H.R. 1 requires any contribution in aid of construction or other contribution by a customer or potential customer and any contribution by a governmental entity or civic group (other than a contribution by a shareholder as such) to be included in the income of the receiving entity. As described in the original House bill summary, this change removes "a federal tax subsidy for state and local governments to offer incentives and concessions to businesses that locate operations within their jurisdiction. The original House bill summary indicated that the section would affect only grants made by governmental entities and would not affect tax abatements. This is not explicitly noted in the explanation of the final conference agreement. The provision applies to contributions made after the date of enactment unless the contribution is made pursuant to a master development plan approved by the governmental entity prior to the date of enactment. The explanatory statement to the conference agreement expresses the intent that section 118 "continue to apply only to corporations." H.R. 1 also eliminates the tax exemption for advanced refunding bonds and the authority to issue tax credit bonds. The exemption for qualified private activity bonds, including those issued to finance professional sports stadiums, is retained.
- **Alternative minimum tax:** H.R. 1 repeals the corporate AMT effective December 31, 2017. Eight states currently have an alternative minimum tax on corporations: Alaska, California, Florida, Iowa, Kentucky, Maine, Minnesota, and New Hampshire. However, the state alternative tax is not computed as a percentage of the federal tax and the repeal of the federal AMT will likely not affect the states.

International provisions

From the start, one of the stated goals of tax reform was to revise the way multinational businesses are taxed. H.R. 1 accomplishes three objectives with respect to the treatment of foreign income and international tax reform: (a) shift the United States from a worldwide system of taxation closer to a system of territorial taxation; (b) transition to the new quasi-territorial system by requiring an immediate repatriation of certain foreign entity earnings and profits that have heretofore been deferred from U.S. taxation; and (c) establish measures to prevent the diversion of income to foreign jurisdictions once the United States moves to the territorial regime, colloquially referred to as "base erosion provisions."

Collectively, these provisions represent a significant shift in the taxation of multinational businesses; they also create some interesting state issues. Unlike the federal system, which has historically taxed multinational businesses on a worldwide basis, states have largely used a territorial approach, including income from wherever earned in the tax base, then attributing income to an individual state through the use of formulary apportionment. In addition, states often take additional steps to deal with foreign-source income, including the use of dividends received deductions for dividends paid by foreign subsidiaries to U.S. parent corporations, subtractions from the tax base for subpart F income, or general exclusions from the tax base for foreign-source income.

There is substantial variation across the states with respect to how foreign income generally, and subpart F income specifically, is handled. As noted in more detail below, the repatriation inclusion amounts in H.R.1 are treated for federal purposes as an addition to subpart F income. The state treatment of subpart F income is far from consistent across states. Certain states provide a specific exclusion from the state tax base for subpart F income. Other states administratively extend their foreign dividends received deduction to subpart F income. A number of states simply do not address subpart F income. Additionally, many states disallow expenses associated with any subpart F income not taxed by the state. These issues are not new, but will likely require closer examination due to the magnitude of the amounts required to be repatriated and included in federal income under H.R. 1.

For states, the dormant foreign commerce clause arising under the U.S. constitution inserts another layer of complexity to the analysis of state taxation of foreign-source income. Unlike the federal government, states are prohibited from taxing foreign income or entities engaged in foreign commerce less favorably than domestic counterparts. The essential principle applicable here was provided by the U.S. Supreme Court in *Kraft General Foods v. Iowa Department of Revenue*, in which the Court determined that Iowa's conformity to federal tax law was an unconstitutional violation of the foreign commerce clause because it resulted in discriminatory treatment of dividends received from foreign affiliates as compared to domestic affiliates. This mandate to avoid discriminating against foreign commerce requires an examination of any state inclusion of foreign-source income (remaining in the state tax base after the application of state-specific subtraction rules) to ensure the foreign income is not taxed more heavily than similarly situated income from domestic sources. To complicate matters further, the application of this principle may differ depending on whether the state is a separate filing state or a state in which a corporate taxpayer files its returns on a combined or consolidated basis.

Establish a territorial tax system

— **Deduction for foreign-source dividends received.** The territorial system encompassed in H.R. 1 allows a dividends received deduction (DRD) for 100% of the foreign-source portion of dividends received from a foreign corporation in which the U.S. recipient owns 10% or more of the voting stock (subject to certain holding period requirements). A "hybrid" dividend is not eligible for this deduction. A hybrid dividend is a dividend paid by the foreign subsidiary for which it received a deduction or other tax benefit in a foreign country. Instead, any hybrid dividend received by a controlled foreign corporation (CFC) from another CFC is treated as subpart F income for the U.S. shareholders.

States often do not conform to the federal tax treatment of foreign affiliate dividends. Many states apply their DRDs in the same manner to both foreign and domestic dividends to avoid unconstitutionally discriminating against foreign dividends. A number of states, but certainly not all, already allow a 100% DRD for dividends from foreign corporations. Some allow only a partial DRD, but tax an equal portion of domestic and foreign dividends. Many states also provide a subtraction from taxable income for subpart F income, either in the form of a specific exclusion of some or all subpart F income or a DRD that includes subpart F income. Now that H.R. 1 has been enacted, taxpayers will need to evaluate how a state conforms to the federal DRD as well as its treatment of subpart F income, thus determining whether the dividends will qualify for deduction or exclusion under state law.

Transition toward a territorial system

— To transition to the territorial system, H.R. 1 requires a deemed repatriation of post-1986 earnings and profits (E&P) of certain foreign corporations and subjects those amounts to reduced federal tax rates depending on whether the E&P relates to cash and cash equivalents or other assets. This is accomplished by adding the post-1986 E&P to the U.S. shareholders' subpart F income and then allowing a partial deduction of those included amounts to effectively arrive at the applicable preferential tax rates. The effective preferential rates on repatriated earnings are 15.5% for cash and cash equivalents and 8% for other amounts. This income inclusion is required in "the last tax year beginning before January 1, 2018." Taxpayers have the option of preserving NOLs, rather than using such NOLs to offset the deemed repatriated E&P.

Certain state issues naturally flow from the mandatory repatriation. Those issues include the interaction between the mechanics of the way deemed repatriated amounts are included in a U.S. taxpayer's federal gross income and the state modifications to federal taxable income that generally apply to subpart F income and foreign dividends. For example, the repatriated amount does not fall within the IRC section 952 definition of subpart F income in the Code, but is an amount added to a taxpayer's subpart F income to be included in federal gross income. That raises questions of whether a state's subpart F modification provision applies to the repatriated amount. Even where the state's subpart F modification includes the repatriated amount, the reduction in some states is less than 100% of that income, resulting in the potential for some residual inclusion in state taxable income as a result of the repatriation. Further, the foreign commerce clause could be implicated if the undistributed earnings of similarly situated domestic subsidiaries are not similarly subject to tax.

H.R. 1 allows the federal tax on repatriated earnings to be paid over eight years, a provision that will not likely be picked up by a state without legislative action (state conformity to the Code generally applies to the calculation of taxable income and not to the payment of tax on that income). As a result, the full amount of any state tax attributable to the repatriation will likely need to be paid in a single year rather than spread over the eight-year federal installment period. Paying the federal tax on repatriated income in installments also affects the timing of any deductions for federal income tax paid in the handful of states that permit a deduction for federal taxes.

Establish measures to prevent base erosion

H.R. 1 includes several sections designed to address potential base erosion on both outbound and inbound transactions. A number of state issues flow from these new rules. Of critical importance is the foreign commerce clause prohibition against discriminating against foreign commerce, even if the differential treatment is the result of conformity to the IRC.

— **Rules related to passive and mobile income.** To address possible abuses related to certain types of income, H.R. 1 requires current recognition of a portion of certain income. Specifically, under H.R. 1, a U.S. parent of a foreign subsidiary includes in gross income what is referred to as the global intangible low-taxed income (GILTI) of the foreign subsidiary. The calculation of this income amount is complicated and is made based on certain enumerated attributes of the domestic corporation's foreign subsidiary. Regardless of whether the foreign subsidiary actually distributes this GILTI income, it must be included in the gross income of the U.S. parent. This income inclusion is required through the enactment of a new Code section 951A. The income included under this provision by the domestic parent is eligible for a potential deduction equal to 50% (37.5% for years beginning after December 31, 2025) of the foreign subsidiary's GILTI (subject to limitation when GILTI exceeds taxable income). This deduction is added to the Code as new section 250, which is the part of the Code addressing special deductions.

  Although GILTI is treated as subpart F income for a number of purposes, it is not included in the definition of "subpart F income" under Code section 952. In addition, the explanatory statement accompanying the conference report specifically states that "GILTI inclusions do not constitute subpart F" income. As such, in many states there may not be a specific provision to rely on to exclude GILTI from the state tax base. In that situation, a taxpayer may need to consider whether a potential foreign commerce clause violation exists if GILTI earned by foreign affiliates is taxed less favorably than similar income of domestic affiliates. If there is such a violation, then that may be a basis for excluding the GILTI. Even if there is an existing state exclusion that might apply to GILTI, there are likely to be issues resulting from the 50% deduction for GILTI in new Code section 250. Specifically, there could be confusion as to how the state subtraction and federal deduction interact.

— **Base erosion minimum tax.** H.R. 1 adopts a new "base erosion minimum tax," which is applicable to certain enterprises with average annual gross receipts in the preceding three years of at least $500 million. The tax is based on the excess income that would have been reported by the domestic corporation without taking into account certain amounts paid to foreign affiliates. Given that this is a new, separate tax calculation, it is possible there will be no state tax effect because the tax will not cause a change to a corporation's federal taxable income. In other words, even a rolling conformity state will likely not conform to the new base erosion minimum tax absent specific legislation.

The above discussion has focused on whether certain foreign-source income will be included in the state income tax base and made note of the U.S. constitutional requirement for its treatment. Beyond this, there are a host of additional considerations that need to be taken into account in cases where some or all of the foreign income gets included in the state tax base. For the most part, these considerations are not new. They include considerations of whether the income is unitary and subject to apportionment or non-unitary and subject to allocation. If subject to apportionment, taxpayers would need to consider the method used by individual states to source that type of income for apportionment factor purposes, which can differ depending on whether the income is from dividends, interest, capital gains, inventory sales, and the like. While not new issues, they will require careful analysis.

Closing thoughts

Given the recent enactment of H.R. 1, four general observations relative to the potential impact on state taxes seem in order. First, from a structural standpoint, the changes envisioned in the individual income tax appear likely to have a greater impact on the states. The repeal of personal exemptions and use of an enhanced child credit as the primary family-size adjustment, the modifications to itemized deductions, and the proposed deduction for owners of passthrough entities could each have a significant impact on the yield and distribution of the personal income tax, depending on how the state responds.

As it relates to purely domestic businesses, the impact appears to be more modest given that the focal point of the federal reform is the substantial reduction in the corporate tax rate. There will likely to be additional complexity as states and taxpayers try to coordinate different filing methods and current state law provisions in such areas as interest limitations, expensing and the like. Finally, the international provisions in H.R. 1 are far-reaching and pose substantial challenges in evaluating whether certain types of income are included in a state return, how that income should be sourced or allocated if it is included, and whether the state treatment presents any potential constitutional challenges. The international changes are ones of kind rather than degree, and they may well overwhelm current state structures for taxing foreign-source income.

In evaluating how states will respond to federal tax reform, state taxpayers are well-advised to keep a few fundamentals in mind. First, the reaction to federal tax reform by individual states will likely to be driven, to a considerable extent, by the fiscal impact of conformity the revised federal tax code. State balanced budget requirements will have an out-sized influence on whether and to what extent states conform to the federal changes. Simply put, states do not have the ability to run a deficit under their typical one- or two-year state budget cycles. While the additional complexity and compliance challenges associated with nonconformity will be evaluated, the fiscal concerns are likely to be paramount.

Second, there will be indirect effects as a result of federal tax reform that states must consider or are currently considering. Certain of the changes, such as curtailing the state and local income and sales tax deduction for individuals, increase the after-tax cost of state and local government at a time when federal resources are likely to be constrained and reduced federal assistance may be available. Even in the relatively short time since the enactment of H.R. 1, it has already been reported that state lawmakers in New York and California are considering reforms to make the repeal of the SALT deduction less harsh for state residents.

Third, for states, the timing of the federal reforms could not be worse. Because H.R. 1 is effective for the 2018 tax year, many states now have a very limited time to assess the fiscal effects of the federal changes before the state legislatures convene. A few states have already proposed bills tying their conformity to the Code to a pre-reform time period. State taxpayers will need to carefully monitor legislation updating conformity statutes in 2018.

Finally, there is no "one size fits all" state response to federal tax reform. The federal changes will affect each state differently and will need to be carefully analyzed by state tax administrators and state legislators before the state can formulate a legislative response. The effect on corporate taxpayers varies widely and depends largely on the taxpayer's particular situation, current state filing position, and industry.