State and Local Tax Implications of Tax Reform

WEDNESDAY, MAY 2, 2018, 1:00-2:50 pm Eastern

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Stephen W. Long, Partner
Baker McKenzie, Dallas
stephen.long@bakermckenzie.com

Michael C. Tedesco, Atty
Baker & McKenzie, New York
michael.tedesco@bakermckenzie.com
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SALT Implications of Federal Tax Reform
Agenda

Corporate Income Tax Reform
  • State Conformity
  • Business Reform Key Provisions
  • International Reform Key Provisions
  • State Legislative Developments

• Personal Income Tax Reform
  • Limit on Deductibility of State & Local Taxes
  • State workarounds
Corporate Tax Reform
State Dependence/Independence with Federal Income Tax Law

- Due to state conformity with federal tax laws, changes at the federal level may flow to state level.
- As a result, federal legislation may increase or decrease state tax revenues.
- States may diverge from federal tax law via state “decoupling” modifications.
- States may also be forced to diverge from federal tax law due to constitutional constraints.
- Taxpayers must separately track, monitor, and implement state modifications to federal provisions.
Conformity Split

- **Rolling**: (Alabama, Alaska, Colorado, Connecticut, Delaware, DC, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Oregon, Rhode Island, Tennessee, and Utah)

- **Fixed**: (Arizona, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, New Hampshire, North Carolina, Ohio, South Carolina, Texas, Vermont, Virginia, West Virginia, and Wisconsin).

- **Selective**: (Arkansas, California, Mississippi, New Jersey, and Pennsylvania)
2018 State Legislative Session Calendar

Source: National Conference of State Legislatures
Map current as of April 20, 2018
Business Tax Reform Key Provisions

**Tax rate**: lowered from 35% to 21%.

- State tax impact: Not much. Rates are not keyed to federal rates. Combined with base-broadening provisions, state tax impact on ETR may increase.
- States may directly counter the rate reduction.
  - e.g., California and New Jersey surcharge proposals.

**Immediate expensing**: 168(k) allows for full & immediate expensing of certain property placed into service between 9/27/2017 and 1/1/2023.

- Many states have decoupled.
  - Pennsylvania Corporation Tax Bulletin No. 2017-02 (Dec. 22, 2017): Pennsylvania law requires the amount of a 100% deduction under IRC 168(k) to be added back to taxable income, and provides no additional mechanism for cost recovery with respect to the qualified property.
Interest deduction: Limited to 30% EBITDA for 4 years, 30% EBIT thereafter, carryforward of disallowed expense.

- States may undermine intended federal policy objective by decoupling from immediate expensing but conforming to the interest deduction limitation (e.g., NY)
- Biggest impact – debt from unrelated lenders.

NOL deductions: Current two-year carryback of NOLs eliminated, but allows indefinite carryforwards (limited to 20 years under current law), subject to a limitation of 80% of taxable income.

- State tax impact: Depends on the state.
Pass Through Income Deduction

- Establishes a 20 percent deduction of qualified business income from certain pass-through businesses. Specific service industries, such as health, law, and professional services, are excluded. However, joint filers with income below $315,000 and other filers with income below $157,500 can claim the deduction fully on income from service industries.
  - This provision would expire December 31, 2025.
  - The deduction is limited to the greater of (i) 50% of the W-2 wages paid with respect to the trade or business or (ii) the sum of 25% of the W-2 wages paid with respect to the trade or business and 2.5% of the unadjusted basis, immediately after acquisition, of all depreciable property used in the qualified trade or business.
  - State tax impact: depends on starting point.
International Tax Reform Key Provisions

- **Participation Exemption System**
  - Under new IRC 245A, eligible dividends a U.S. corporation receives from an eligible foreign corporation qualify for 100% deduction. As a result, qualifying dividends are only subject to foreign tax and effectively are exempt from U.S. tax.
  - State tax impact: most states permit deductions for dividends received from related corporations. However, constitutional problems arise if a state does not provide a similar 100% deduction for dividends received from domestic corporations.
  - States may choose to modify 100% deduction to align with treatment of domestic dividends.
• **Repatriation Transition Tax:**
  • Accumulated foreign earnings held by CFCs of a US shareholder will be deemed repatriated and taxed federally at a rate of 15.5% if attributable to cash or cash equivalents and at a rate of 8% if attributable to illiquid assets.
    • Mechanically, consists of an addition under 951(a) and a deduction under 965(c).
  • The taxpayer may then elect to pay the resulting federal income tax liability over an eight-year period.
  • State tax impact:
    • The RTT Addition included in federal taxable income under 951(a) should automatically result in an increase to that state tax base in rolling conformity states unless the state has a specific exclusion for such income (e.g., exclusion for CFC income).
    • The RTT Deduction may or may not be allowed for state purposes depending on how state defines its base (i.e., taxable income or by reference to Line 28).
    • Deferral: Likely not applicable for state purposes, unless specifically allowed.
International Tax Reform Key Provisions (cont.)

- Repatriation Transition Tax: Steps to Analyzing SALT Consequences in States Where It Has Not Been Addressed:
  - **Step One**: What is the state’s conformity to the IRC?
  - **Step Two**: How does the state define and treat “Subpart F” income?
  - **Step Three**: How will states treat the 965(c) deduction?
  - **Step Four**: If there is an inclusion, do other arguments exist to reduce/eliminate the income (e.g., DRD, nonbusiness, or constitutional arguments)?
  - **Step Five**: If there is an income inclusion, is apportionment relief available (e.g., sourcing or factor representation)?
International Tax Reform Key Provisions (cont.)

- Note that the Repatriation Transition Tax is not reported directly on the Form 1120, but instead on Transition Tax Statement attached to the Form 1120. Does that matter? It may.

- Illinois Informational Bulletin FY 2018-23
  - “Due to the separate nature of the IRC 965 Transition Tax Statement, the income reported may not be included in federal taxable income; however, it must be included when determining Illinois base income.”

- Tennessee Franchise and Excise Tax Notice 18-05
  - “Corporations will report repatriated earnings on the IRC 965 Transition Tax Statement and not on Federal Form 1120. Thus, repatriated earnings should not be included in the net earnings calculation on Schedule J-4.”

- Rhode Island ADV 2018-19
  - “Guidance to come”
Global Intangible Low-Taxed Income (GILTI): tax on a US shareholder’s share of its CFCs’ global intangible low-taxed income at a reduced effective rate of 10.5 percent (13.125 percent beginning in 2026). Intended to tax portion of CFC’s active income equal to the excess of an imputed 10 percent rate of return on the CFC’s adjusted bases in tangible depreciable property used to generate the active income.

Like RTT, mechanically consists of addition (new IRC 951A) and smaller deduction (new IRC 250).

State tax impact:
- GILTI Addition: Likely included in base absent statutory exclusion.
- GILTI Deduction: Special deduction under IRC 250, so inclusion in base depends on whether before or after special deductions.
- For both RTT and GILTI, must consider characterization (business/nonbusiness) and apportionment (factor representation).
International Tax Reform Key Provisions (cont.)

- **GILTI**: Steps to Analyzing SALT Consequences in States Where It Has Not Been Addressed:
  - **Step One**: What is the state’s conformity to the IRC?
  - **Step Two**: Is this “Subpart F” income?
  - **Step Three**: How will GILTI income be treated by states?
  - **Step Four**: How will states treat the special deduction?
  - **Step Five**: If there is an inclusion, do arguments exist to eliminate or reduce the income (e.g., nonbusiness and other constitutional arguments)?
  - **Step Six**: If there is an income inclusion, should there be factor relief?
Foreign-Derived Intangible Income (FDII):

- Unlike GILTI, FDII is not a new bucket of income, but instead, a preferential rate for above-routine income arising from foreign markets.
- Eligible corporations will pay an effective rate of 13.125% on this income.
- The effective rate is achieved through a deduction in IRC 250
- This deduction is only available to C corporations
- Like GILTI, a key question for state tax purposes is whether this deduction under IRC 250 will be permitted in the state tax base.
• **Base Erosion Minimum Tax (BEAT):** An alternative minimum tax on amounts considered “base-eroding” payments, equal to the excess (if any) of a percentage of the corporation’s modified taxable income over a taxpayer’s regular tax liability, reduced by specific credits.

• Unlikely to be a concern at the state level initially, but is worth watching.
General Considerations for States

• Federally, the increase to taxable income caused by the base broadening provisions is tempered by a reduction in the corporate tax rate from 35% to 21%. Because most state income tax regimes key off of taxable income for federal income tax purposes, the base broadening provisions of the federal tax reform bills will have implications for state income taxes, but without the tempering of the federal rate reduction.

• **Timing will be important and difficult for states.**
  • Every state needs to decide something – Will likely lead to special sessions and substantial non-conformity in the near to medium term.

• **States have balanced budget requirements and caution on revenues is likely to lead to a conservative response.**
  • Dealing with changes of this magnitude will be difficult for states to analyze and assess.
  • States may look at alternative taxes such as gross receipts taxes.

• **Unlike Congress, states have Commerce Clause issues and must fairly apportion tax and cannot discriminate against interstate or international business.**
  • E.g., States would have difficulty conforming to BEAT under the Foreign Commerce Clause.
What to Expect

- Increased focus on state tax.
  - Increase in base/liabilities.
  - Increase in ETR impact.
- Divergent responses motivated by political climates.
- For simplification, states may look at alternative taxes such as gross receipts taxes.
Legislative Developments

- **Arizona**—Updated IRC conformity to include TCJA
- **Florida**—Updated IRC conformity to IRC as of 1/1/18
- **Georgia**—Conforms to IRC as of 2/9/18. Decoupled from interest limitation and full expensing. Specified that GILTI qualifies for DRD. Permits deductions under 965, 250, and 245A to the extent included in Georgia income.
- **Idaho**—Adopted RTT, but disallows 965(c) deduction. For 2018 tax year, adopts IRC as of 1/1/18, but disallows 250 deduction.
- **Nebraska**—Adopted IRC as of 4/11/18
- **New York**—Exempts RTT income, requires addback of 965(c) deduction, requires FDII deduction addback
- **Oregon**—Conforms to IRC as of 12/31/17; requires 965(c) addback; requires DoR to compare GILTI to tax have addback
- **South Dakota**—For 2018 tax year, adopts IRC as of 1/1/18.
- **Utah**—Allows for RTT to be paid in installments mirroring federal provisions
- **Virginia**—Conforms to IRC as of 2/9/18 for 2017 tax year only. Does not conforms to most provisions of TCJA for years after 2017.
- **West Virginia**—Adopted changes to IRC made after 12/3/16, but before 1/1/18.
- **Wisconsin**—Updated to conformity to IRC as of 12/31/17, but explicitly did not adopt many of the most significant TCJA changes including RTT, GILTI (income and deduction), FDII, and the participation exemption.
States to Watch

- **Hawaii**-SB 2821-Would adopt IRC 12/31/17, but excluded GILTI and FDII deductions
- **Indiana**-Special session has been called to address conformity issue
- **Iowa**-SF 2383-Would provide rolling conformity beginning on 1/1/19
- **Minnesota**-HF 2942, SF 2529, SF 2982/HF 3995, HF 3656/SF 3162-Multiple bills pending
- **North Carolina**-North Carolina Revenue Laws Study Committee has released draft legislation, but no pending bills
- **South Carolina**-HB 5162-Annual conformity update, which has not been passed
Individual Tax Reform
Individual Tax Reform: Repeal of SALT Deduction

- Section 11042(a)(6) limits the SALT deduction to a total of $10,000 (income, property, sales, etc.).
- State workarounds:
  - Charitable contributions in lieu of state income tax.
  - Switch to employment/payroll taxes.
  - Pass-through entity taxes.
- Residency issues matter now more than ever.
  - New York State/City: domicile vs. 183-day test.
Elimination would significantly affect the federal income taxes that individuals pay.

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Employer Compensation Expense Program (New York)

- Optional payroll tax
  - Electing employers are subject to tax on payroll expenses paid to “covered employees,” i.e., employees whose wages are subject to withholding and who receive annual wages and compensation in excess of $40,000.
  - Gradually phased-in rate
    - 2019 – 1.5%
    - 2020 – 3%
    - 2021 and later – 5%
- Employee credit provided. May be carried forward to succeeding years.
- First election due December 1, 2018.
Connecticut Proposal (S.B. 11)

- Entity-level tax imposed on the net income of pass-through businesses at a 6.99% rate.
- Provides a corresponding credit for pass-through business owners.
- Potential constitutional problems under *Wynne*. 
Repeal of SALT Deduction: State Workarounds
Charitable Contributions in Lieu of State Income Tax

• New York - Charitable Gifts Trust Fund (enacted)
  • Creates a state-run charitable fund for the benefit of New York health and education initiatives.
  • Allows a New York personal income tax credit equal to 85% of contributions to the fund in the immediately preceding calendar year.

• New Jersey (passed both legislative chambers)
  • Authorizes localities to create charitable funds that give donors property tax credits of up to 90% of their contributions.

• Other Proposals:
  • California
  • Maryland
  • Illinois