

TCJAs Implications for State Corporate and Personal Income Taxes and The Cost of Tax Compliance and Administration

Presenter:

Daniel R. Mullins, Ernst & Young, LLP

Quantitative Economics & Statistics

National Director, State and Local Tax Policy Economics

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2018 state tax trends

- ▶ States responding to the Tax Cuts and Jobs Act (TCJA)
- ▶ States responding to the U.S. Supreme Court ruling in *South Dakota v. Wayfair*
- ▶ Corporate and individual income tax rate cuts
- ▶ State level tax reform
- ▶ Continued move to single sales factor apportionment and market-based sourcing for sales of non-tangible property
- ▶ States designate federal Opportunity Zones
- ▶ Sales tax base expansion to include services, streaming, sharing

TCJA – overview of major provisions



Top individual provisions

- ▶ Seven brackets; 10%, 15%, 22%, 25%, 32%, 35%, 37%
- ▶ Standard deduction: \$24K joint, \$12K single filers; personal exemptions repealed
- ▶ Net capital gains and qualified dividends retain current law; subject to 3.8% net investment income tax
- ▶ Individual AMT retained; exemption amount increased; phase out of exemption increased
- ▶ Estate tax exclusion increased to \$11.2M
- ▶ Child tax credit increased to \$2K, \$1,400 refundable; phase out increased to \$200K (single) and \$400K (married filing jointly)
- ▶ Principal cap on deductible home mortgage interest for new mortgages (after 12/15/17) reduced from \$1M to \$750K; deduction retained for second homes, but no longer available for home equity lines
- ▶ Itemized deductions subject to 2% floor repealed
- ▶ Eliminate moving expense
- ▶ 529 education savings account expansion
- ▶ Medical expense deduction would apply to expenses that exceed 7.5% of AGI in 2017 and 2018 and expenses that exceed 10% of AGI thereafter
- ▶ 50% AGI limitation for charitable contributions increased to 60% for gifts of cash to specified organizations
- ▶ State and local deduction available for \$10K of property and income (or sales) taxes
- ▶ ACA “shared responsibility payment” reduced to \$0
- ▶ Disallow active pass-through losses exceeding \$500,000
- ▶ 30% ATI interest expense limitation
- ▶ Limit deduction of fringe benefits



Top business provisions

- ▶ 21% corporate rate, beginning 2018; AMT repealed
- ▶ 20% deduction for domestic “qualified business income” from a partnership, S corporation, or a sole proprietorship
- ▶ Limits interest deduction to 30% of earnings before interest, tax, depreciation and amortization (EBITDA) for four years, thereafter 30% of earning before interest and tax (EBIT); worldwide debt limit removed
- ▶ Bonus depreciation increased from 50% to 100% for “qualified property” placed in service after 9/27/17; starting in 2023 phase-down of 20% for five years
- ▶ Significant net operating loss changes
- ▶ Expands definition of covered employee for purpose of compensation deduction limits (\$162(m))
- ▶ Establishes exemption for dividends received by US corporations from 10%-owned foreign corporations
- ▶ Transition tax on deferred foreign earnings: 15.5% (cash)/8% (non-cash)
- ▶ New broad-based anti-deferral provision taxes global intangible low-taxed income (GILTI) on a current basis at 10.5% effective tax rate (some FTCs available)
- ▶ New deduction for “foreign-derived intangible income” (FDII)
- ▶ R&E expenditures to be capitalized and amortized over 5 years (15 years for R&E conducted outside the US) starting in 2022
- ▶ Minimum tax of 10% (5% transition rate in 2018) applied on income determined after adding back deductible payments made to related foreign persons (BEAT)

Selected TCJA tax rates and thresholds

Individuals		
Individual rates	10% rate – first \$9,525 (ind.)/\$19,050 (joint) 12% rate — \$9,525/\$19,050 22% rate — \$38,700/\$77,400 24% rate — \$82,500/\$165,000 32% rate — \$157,500/\$315,000 35% rate — \$200,000/\$400,000 37% rate — \$500,000/\$600,000	Tax years beginning after 2017 and before 2026
Individual AMT	<ul style="list-style-type: none"> ▶ Exemption – \$70,300/\$109,400 ▶ Phase-out – \$500,000/\$1,000,000 	Tax years beginning after 2017 and before 2026
Standard deduction	\$12,000/\$24,000 (indexed)	Tax years beginning after 2017 and before 2026
Estate, gift, and generation-skipping tax (GST)	Exemption – \$10 million (indexed from 2011)	Tax years beginning after 2017 and before 2026
Business		
Top corporate rate	21% (no graduated rates)	January 1, 2018
Corporate AMT	Repealed – AMT credit refunds – 50% per year (100% for years beginning in 2021)	Tax years beginning after 2017
Top pass-through rate	<ul style="list-style-type: none"> ▶ 29.6% (20% deduction) ▶ Wage limitation – \$157,500/\$315,000 ▶ Specified service business exclusion (phase-in) – \$157,500-\$207,500/ \$315,000-\$415,000 	Tax years beginning after 2017 and before 2026
Limitation on pass-through losses	\$250,000/\$500,000 (indexed)	Tax years beginning after 2017 and before 2026

Selected TCJA tax rates and thresholds, cont.'d

International		
Type of system	Territorial, 100% dividends received deduction	Distributions made after December 31, 2017
Transition tax	15.5% (cash, etc.) / 8% (other)	Last tax year of the foreign corporations beginning before January 1, 2018
Global Intangible Low-Taxed Income (GILTI)	<ul style="list-style-type: none"> ▶ GILTI – Net CFC Tested Income minus (10% x QBAI) ▶ Deemed-paid foreign tax credit – 80% 	Tax years of foreign corporations beginning after December 31, 2017
Deduction for Foreign-Derived Intangible Income (FDII) and GILTI	<ul style="list-style-type: none"> ▶ GILTI (before 2026) – 50% (10.5% effective tax rate) ▶ GILTI (after 2025) – 37.5% (13.125% effective tax rate) ▶ FDII (before 2026) – 37.5% (13.125% effective tax rate) ▶ FDII (after 2025) – 21.875% (16.406% effective tax rate) 	Tax years beginning after December 31, 2017
Base Erosion and Anti-Abuse Tax (BEAT)	<ul style="list-style-type: none"> ▶ Gross receipts test – \$500 million average preceding 3 years ▶ Base erosion percentage test – 3% (base erosion tax benefits divided by total deductions) for non-banks/dealers and 2% for banks/dealers ▶ Base erosion minimum tax – excess of [%] of modified taxable income (MTI) over regular tax, reduced by a portion of credits other than R&D ▶ Applicable [%] of MTI: ▶ First tax year beginning after 2017 – 5% (6% for banks/dealers) ▶ Tax years beginning after 2018 and before 2025 – 10% (11% for banks/dealers) ▶ Tax years beginning after 2025 – 12.5% (13.5% for banks/dealers) ▶ For tax years beginning after 2025, regular tax is reduced by all credits in full 	Tax years beginning after December 31, 2017

Timeline of notable events

Next steps	Jan 2019	Calendar year-end public companies prepare to file Form 10-K and evaluate estimated taxes paid for TY2018
	Oct 2018	Corporations file extended state income tax returns for TY2017
State responses	Aug 2018	Release of proposed Treasury Regulations addressing key TCJA provisions; state taxing authorities step up publication of updated tax forms and TCJA information notices
	Jun 2018	Most state legislative sessions end June 30, with conformity bills enacted, opening the door for state taxing authorities to interpret laws and issue administrative guidance on state tax impacts of TCJA provisions
	Mar 2018	Georgia, Idaho, and other states begin to enact tax laws that specifically address TCJA provisions relative to each state's tax policy
	Feb 2018	West Virginia becomes the first state to enact new corporate tax laws that intersect with the TCJA, ushering in a period of highly-active state legislative sessions addressing state taxes
TCJA	Dec 2017	President Trump signs into law P.L. 115-97, the "Tax Cuts and Jobs Act"

State conformity to federal tax law changes

- ▶ The Internal Revenue Code (IRC) and resulting FTI typically is the starting point for determining state corporate taxable income:
 - ▶ When the IRC changes (e.g., base expansion, elimination of deductions, modifications of credits), the state tax base typically changes as well.
- ▶ States have different approaches in conforming to the IRC:

“Fixed”
<ul style="list-style-type: none">• Conformity generally not automatic (state conforms to the IRC as of a specific date)• Legislature can consider whether and when to conform to IRC changes

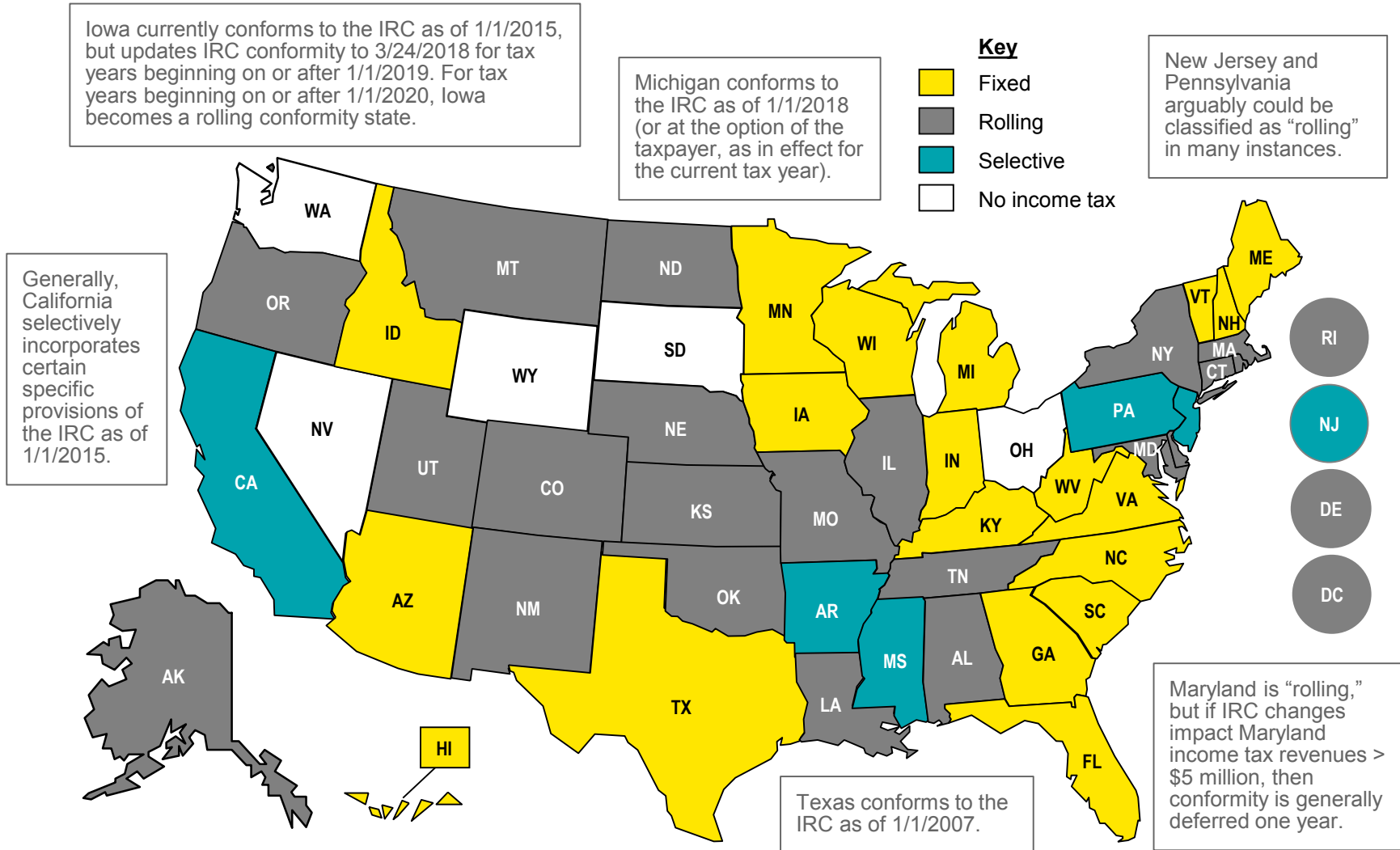
“Rolling”
<ul style="list-style-type: none">• Conformity generally automatic (state automatically conforms to the IRC as enacted)• Legislature must affirmatively consider whether to decouple from IRC changes

“Selective”
<ul style="list-style-type: none">• Conformity generally depends• Legislature can consider whether and when to conform to IRC changes

Note: “Selective” states **generally** adopt only certain specific provisions of the IRC (typically, but not always, as of a specific fixed date) or there are other circumstances that warrant the designation.

Conformity to IRC (corporate income tax)

As of June 12, 2018



State conformity with major federal provisions affecting corporate tax base

Federal	States
Corporate tax rate reductions	States with own rates
Special 20% pass-through entity (PTE) deduction	Potentially impacts minority of states tied to federal “taxable income” for personal income tax (PIT) purposes
Limitation in deduction of business interest expense that exceeds 30% of adjusted taxable income	State conformity (uncertain application to state filing groups)
Fully expensed investments	Two-thirds of states opting out of bonus depreciation
Broadened tax base includes repeal of Section 199 domestic production deduction	State conformity (although many states already opted out of the domestic production deduction)
Limit NOL deductions	Most states with own NOL provisions
Amortization of research and experimental expenditures	State conformity

State conformity with major federal provisions affecting corporate tax base

Federal	States
100% dividends received deduction (DRD) for foreign dividends; reduced domestic DRD percentages	Most states with their own DRDs
Transition tax on “deemed” repatriated earnings	One-quarter of states taxing some portion of Subpart F income and/or foreign dividends
Tax on global intangible low tax income (GILTI) earned by foreign subsidiaries	Likely state conformity (but constitutional limitations)
Deduction of 50% of GILTI income	Partial state conformity (but special deduction linkage issues)
Reduced tax on foreign derived intangible income (FDII) of US corporation	Partial state conformity (but special deduction linkage issues)
Base erosion alternative minimum tax (BEAT)	Separate tax base not in federal taxable income; states don’t conform

State personal income tax conformity

Personal Income Tax Conformity


<u>Provision</u>	<u>States</u>	<u>Provision</u>	<u>States</u>
Rolling IRC	18	Mortgage interest	30
Fixed IRC	19 (4)	Medical expense	31
Selective IRC	4	Property tax	25
Non IRC	5	Child tax credit	3
Federal AGI	31	529 Education	33
Federal TI	6	Filing status	31
Standard deduction	9	Itemized deductions	10
Personal exemption	9	Sec. 179 expensing	36
Moving expense	30	Passthrough deduction	6

Sources: FTA, Tax Foundation

Expiration dates of various tax provisions

Provision	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Individual rate cuts											
21% corporate rate											
20% pass-through deduction											
100% expensing – effective 9/27/17											
Individual AMT exemption amount											
Corporate AMT repeal											
Interest deduction 30% of EBITDA							(EBIT after 2021)				
Amortization of R&D expense											
Estate tax doubled exemption											
\$10,000 State and local deduction											
Alcohol tax modernization											
Medical deduction 7.5%/AGI floor											
More than two dozen extenders											
Other extenders: CFC look-through, NMTTC, WOTC											

ACA taxes*	2018	2019	2020	2021	2022
Cadillac tax					
Device tax					
HIT					

 House Republicans proposing permanent repeal of the medical device tax, a two-year delay of the health insurance tax, one additional year of delay in the implementation of the law's "Cadillac Tax"

Avenues for changes/clarifications to TCJA

1

Treasury regulations

The Treasury Department is writing regulations to implement the TCJA. Lawmakers are insistent that congressional intent be followed. There is a memorandum of agreement between Treasury and OMB

2

Technical corrections bill

House Republican leaders are considering a technical corrections bill following the November elections. There will likely be no movement on technical corrections prior to the midterms.

3

Joint Committee on Taxation Bluebook

Explanation of the TCJA is anticipated to be published by the end of this Congress (end of 2018).

4

Policy changes

Legislation could address policy issues that are more substantive than technical corrections and have revenue consequences.

House Ways & Means (Brady's) GOP Tax Reform 2.0 (three bills)

- ▶ House approved package September 27-28, Senate action unlikely before elections
- ▶ Democrats oppose tax cut extensions, package won't have reconciliation process afforded to TCJA
- ▶ Retirement provisions have the best prospect of being enacted this year, in a lame-duck session

TCJA extensions

- ▶ TCJA provisions expiring at the end of 2025 that would be made permanent under the **Protecting Family and Small Business Tax Cuts Act of 2018** (H.R. 6760) include:
 - 10%, 12%, 22%, 24%, 32%, 35%, and 37% individual income tax rate brackets
 - 20% deduction for the qualified business income of pass-through entities
 - \$10,000 annual limit on the amount of state and local taxes an individual can deduct
 - Increased standard deduction (\$12,000/individuals, \$24,000/married filing jointly)
 - Increase in, and other modifications to, the Child Tax Credit
 - Doubled exemption from the estate tax
 - Increased Alternative Minimum Tax (AMT) exemption amount
- ▶ The itemized deduction for unreimbursed medical expenses exceeding 7.5% of income would be extended for 2 additional years, 2019-2020 (10% thereafter).

Innovation

- Provisions in the **American Innovation Act of 2018** (H.R. 6756) include those to:
- Increase the deduction for business start-up costs from \$5,000 to \$20,000, phased out for costs that exceed \$120,000 (up from \$50,000)
 - Expand the use of net operating losses in certain situations

House Ways & Means GOP Tax Reform 2.0 (three bills) cont'd.

Retirement savings

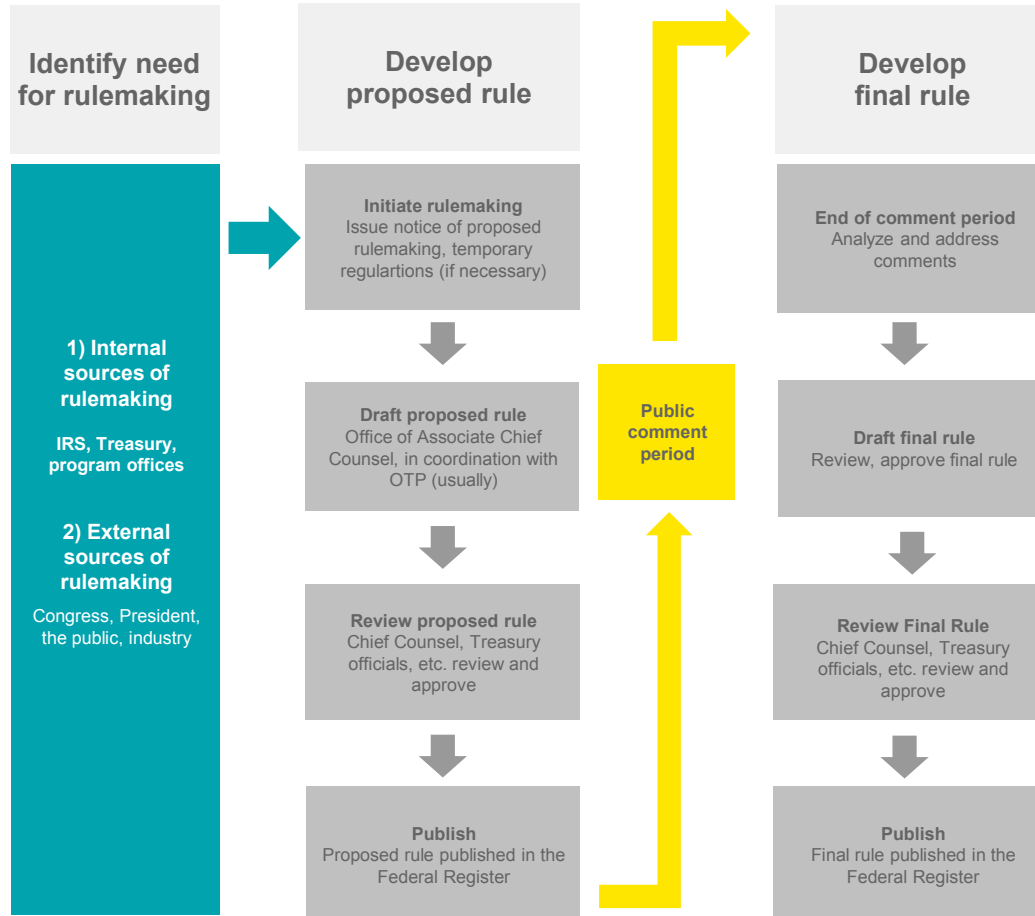
- ▶ Retirement provisions in the **Family Savings Act of 2018** (H.R. 6757) would:
 - Expand retirement plan coverage of small businesses through the creation of open multiple employer plans (MEPS)
 - MEPS allow small businesses to band together to provide plans
 - Repeal maximum age for contributing to a traditional IRA
 - Ease portability of lifetime income investments in plans
 - Block loans from qualified employer-provided plans through credit cards
 - Provide relief to frozen defined benefit plans
 - Exempt from required minimum distribution rules individuals whose aggregated account balances total less than \$50,000

Family savings

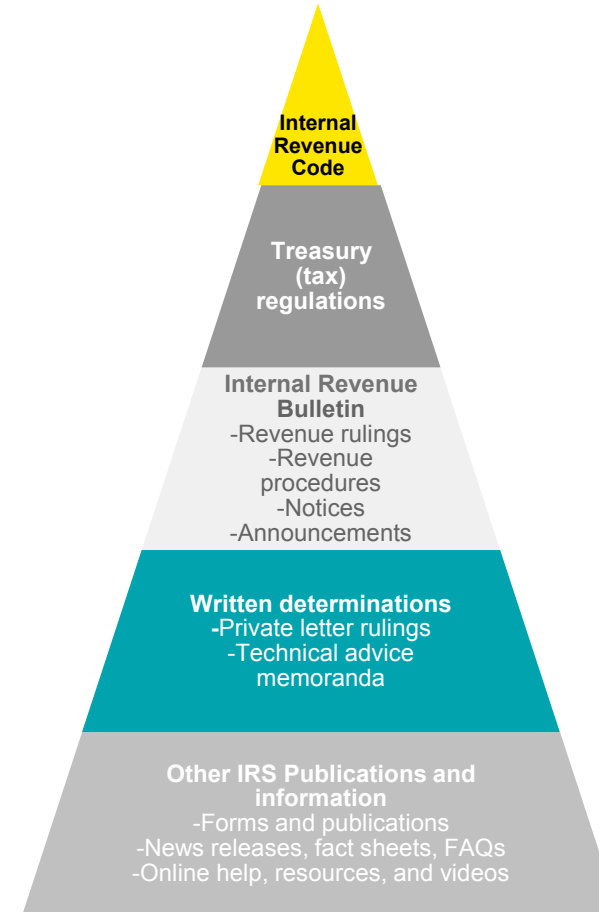
- ▶ Other provisions in the **Family Savings Act of 2018** would:
 - Establish Universal Savings Accounts, allowing annual cash contributions up to the lesser of \$2,500, indexed for inflation, or the gross income of the individual
 - Distributions could be taken at any time for any purpose
 - Expand Section 529 plans to cover apprenticeships, homeschooling expenses, and student loan repayments
 - Allow penalty-free, but not tax-free, withdrawals from qualified retirement plans for expenses related to the birth/adoption of a child in the first year after the birth/adoption
 - Amount that can be withdrawn penalty-free capped at \$7,500

Making the regs: IRS rulemaking process

IRS rulemaking process



Hierarchy of authority for IRS guidance and information



Priority Treasury/IRS guidance

Regulations	Publication	Comment period	IRS hearing
Section 965 transition tax (REG-104226-18)	Released August 1, published in Federal Register August 9	60 days, ending October 9	
Additional First Year Depreciation Deduction, Section 168(k) (REG-104397-18)	Released August 3, published in Federal Register August 8	60 days, ending October 9	
Section 199A pass-through deduction (REG-107892-18)	Released August 8, published in Federal Register August 16	45 days, ending October 1	October 16
Section 162(m) deduction limit for remuneration paid to certain employees (Notice 2018-68)	Released August 21	Ends November 9	
Contributions in Exchange for State or Local Tax Credits (REG-112176-18)	Released August 23, published in Federal Register August 27	45 days, ending October 11	November 5
Section 951A, Global Intangible Low-Taxed Income (REG-104390-18)	Released September 13, set to be published in Federal Register October 10	60 days	
Proposed Removal of Section 385 Documentation Regulations (REG-130244-17)	Released September 21, published in Federal Register September 24	90 days, ending December 24	

Guidance anticipated by the end of 2018:

- ▶ Interpretation of Opportunity Zones provisions – Under OMB review
- ▶ Section 59A base erosion anti-abuse tax (BEAT)
- ▶ Section 163(j) interest deduction limitation
- ▶ Foreign tax credit issues arising under the TCJA

TCJA state and local considerations - overview

Key TCJA state income tax issues



Conformity to Internal Revenue Code

- ▶ The Internal Revenue Code (IRC) and resulting federal taxable income (FTI) is typically the starting point to determine state taxable income
- ▶ States differ on federal conformity, and IRC conformity dates are key
- ▶ “Rolling” vs. “fixed” vs. “selective” conformity



Interest expense limitation

- ▶ 30% business interest limitation may conflict with state related-party interest expense addback rules
- ▶ Certain states might seek to determine the limitation at the individual entity level
- ▶ Immediately reevaluate existing debt structures for state tax purposes too?



Transition tax / future distributions

- ▶ Will states have their own “transition tax”?
- ▶ This 2017 tax year event will have state tax implications too
- ▶ State approaches to subpart F income vary widely (some might not tax at it all), and state-specific expense disallowance rules for any non-taxed subpart F income must be considered
- ▶ Future actual distributions that are not taxable for federal purposes may still be taxable in certain states, particularly California

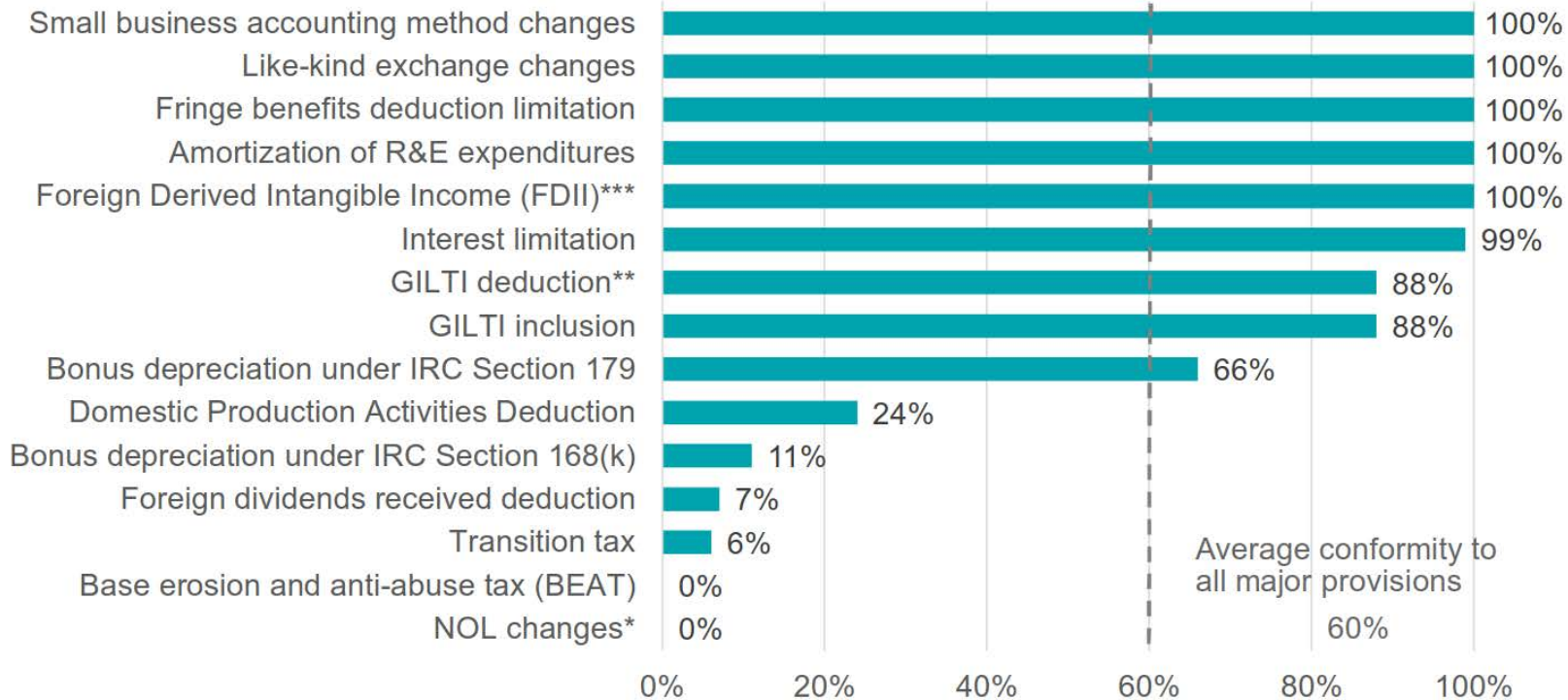


Anti-deferral / anti-base erosion

- ▶ New anti-deferral “carrot” and “stick” provisions impact FTI, but will conforming states statutorily treat “global intangible low-taxed income” the same as current categories of subpart F income?
- ▶ New base erosion and anti-abuse tax on certain payments to foreign affiliates is a new federal tax regime to which the states may not conform

Share of major federal corporate tax provisions impacting states

Assumed share of federal corporate tax base change impacting state corporate tax bases, assuming updated conformity to 1/1/18 IRC, 2018-2027



* While there would likely be some impact from federal NOL changes, no impact is assumed in the analysis

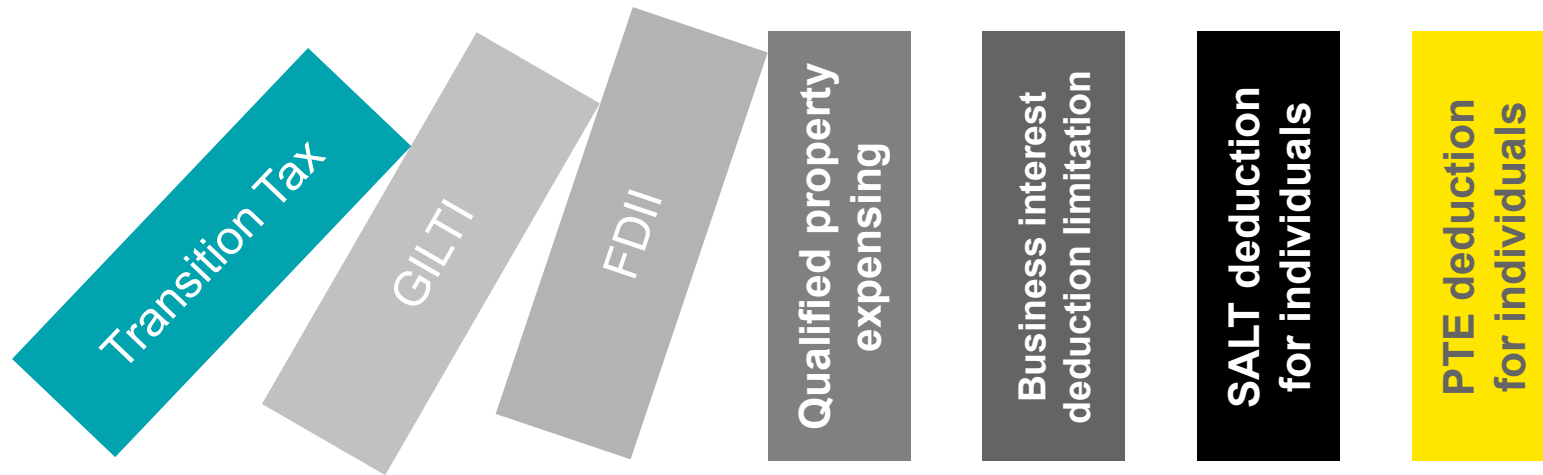
** Deduction is assumed not to be available in states that exclude the related income from the tax base

*** Considerable uncertainty about state conformity to IRC Section 250 GILTI and FDII deductions exists



State responses to TCJA

State legislative and administrative responses to date have primarily focused on the following TCJA provisions:



Overlooked so far?

- ▶ Foreign DRD, BEAT, and hybrid entities and arrangements
- ▶ Changes to NOL deductions

State responses to TCJA (June 26, 2018)

TCJA provision / State proposal	State actions
IRC conformity update bills (14/2)	Enacted: AZ, FL, GA, HI, ID, IN, IA, KY, MI, NC, OR, VA, WV, WI Proposed: MN (vetoed), VT (vetoed)
IRC §965 (transition tax on accumulated foreign earnings) (8/5/14)	Enacted: ID, IN, GA, NY, NC, OR, UT, WI Proposed: ME, MD, MA, MN (vetoed), NJ Guidance: AL, AZ, CA, CO, CT, FL, IL, MA, NJ, NY, OR, PA, RI, TN
IRC §245A (future foreign DRD), §250 (FDII/GILTI deduction), §951A (GILTI) (7/4)	Enacted: GA, HI, ID, IN, NY, NC, WI Proposed: IL, MA, MN (vetoed), NY
30% business interest expense limitation (IRC §163(j)) (5/2)	Enacted: CT, GA, IN, TN, WI Proposed: NJ, NY
PTE deduction (IRC §199A) (7/4)	Enacted: CT, HI, IN, KY, OR, WI - decouple; IA (allow) Proposed: ME, MT (proposed reg.), NJ, NM
Bonus depreciation (IRC §168(k)) (6/4)	Enacted: CT, FL, IA, KY, OH, WI – all decouple Proposed: ME, NY, PA (couple)(approved by legislature), TN (couple)
SALT cap workaround/charitable contribution in lieu of tax (4/6)	Enacted: CT, NY, NJ, OR Proposed: CA, DC, ID, MD, RI, WA
Carried interest fee (0/5)	Proposed: CA, IL, NJ, NY, RI
Employer payroll tax (1/0)	Enacted: NY
New entity level tax on PTEs (1/2)	Enacted: CT Proposed: CA, NY

International provisions, Section 965, Transition Tax

Key state considerations include:

▶ **Conformity or parity to federal tax law:**

- ▶ Consider the impact of various guidance issued by the Internal Revenue Service (IRS), including reporting guidance and the proposed Treasury Regulations. Might certain states require re-computation of the Section 965(b) reduction?
- ▶ In non-conforming states, consider the necessity of state-only subpart F income re-computations.
- ▶ States generally do not conform to the Section 965(h) election to pay the Transition Tax in installments.

▶ **State modifications to federal taxable income (FTI):**

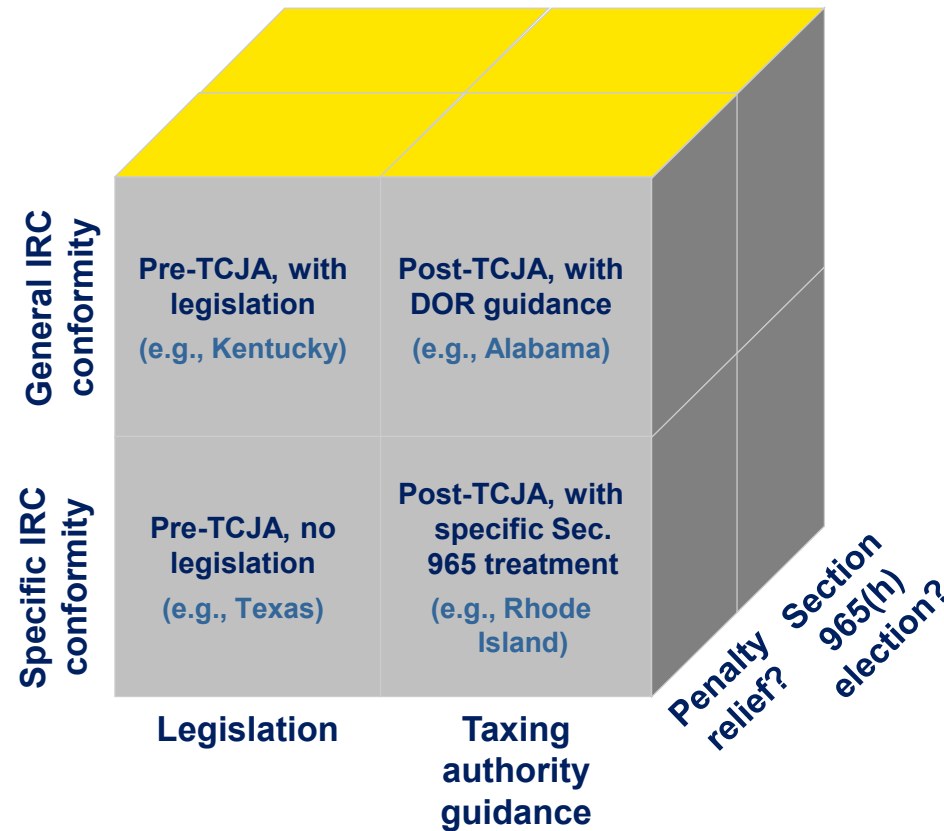
- ▶ Such modifications are generally driven by a state's treatment of subpart F income and foreign dividends (e.g., ownership-based rules).
- ▶ States that exclude Section 965 income (in whole or in part) may disallow expenses attributable to such non-taxable income.
- ▶ States may decouple from the Section 965(c) deduction.

▶ **Apportionment:**

- ▶ Consider the impact on state apportionment factors and the ability to qualify for special state elections or qualifications.

International provisions, Section 965, Transition Tax

State legislative and administrative responses to the Transition Tax have varied significantly across the US.



International provisions, Section 951A, GILTI inclusion

- ▶ How a state treats GILTI may not necessarily depend upon how the state treats existing subpart F income under Section 951(a):

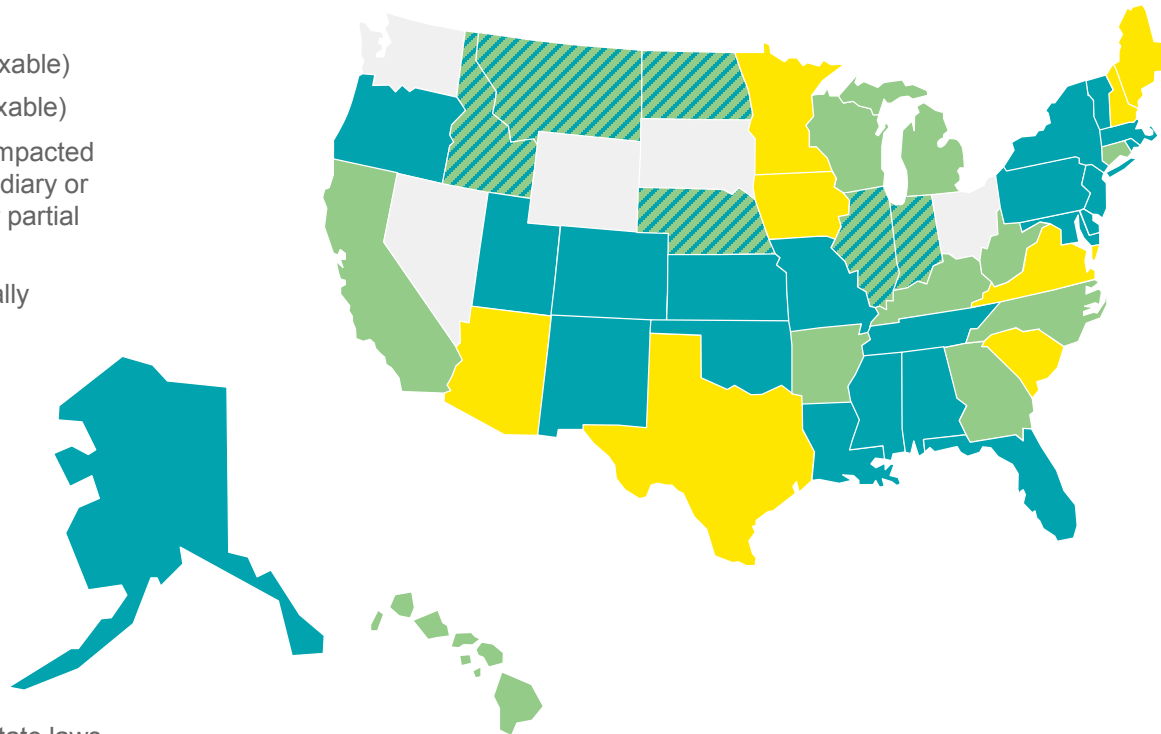
GILTI \neq Section 951(a) inclusion, *or*
Section 952 subpart F income, *or*
Deemed distribution from earnings and profits (E&P), strictly speaking

- ▶ Determining the state treatment requires careful analysis of state statutory conformity to the federal determination of taxable income and presumably the Subpart F regime.
- ▶ How the GILTI inclusion will be reported on the federal income tax return could impact the resulting state income tax treatment in some states:
 - ▶ The IRS recently published a [draft 2018 Form 1120](#) which ultimately reports the GILT inclusion on Page 1, Line 4 (“Dividends and inclusions”).
- ▶ There is uncertainty as to how GILTI will be treated for apportionment factor representation purposes.
- ▶ State conformity to the federal GILTI provisions raises numerous US Constitutional issues.

International provisions, Section 951A, GILTI inclusion

A majority of states imposing income tax will potentially tax at least some component of a US corporate shareholder's GILTI inclusion in the 2018 tax year.

- Key**
- Pre-TCJA fixed conformity (not taxable)
 - Full modification (generally not taxable)
 - Special rules (taxability typically impacted by percentage ownership of subsidiary or state return filing methodology) or partial modification
 - No modification to federal (generally taxable)
 - No corporate income tax

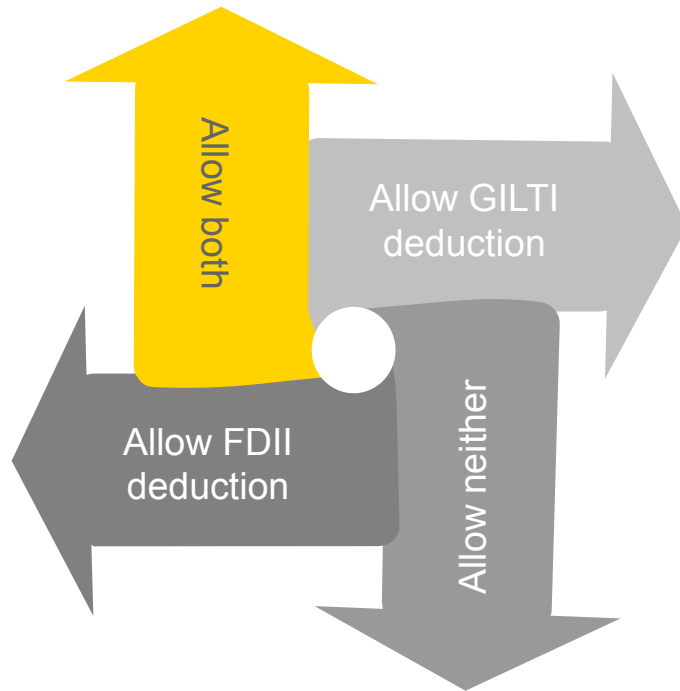


Source: Ernst & Young LLP analysis of state laws as of August 30, 2018 (exceptions may apply)

International provisions, Section 250, deduction for GILTI and FDII

- ▶ How this new deduction will be reported on the federal income tax return could impact the resulting state income tax treatment in some states:
 - ▶ Section 250 is included in Part VIII of Subchapter B of Chapter 1 of Subtitle A of the IRC which “houses” many (but arguably not necessarily all) “special deductions.”
 - ▶ The IRS recently published a [draft 2018 Form 1120](#) which ultimately reports the deduction on Page 1, Line 29b (“Special deductions”):
 - ▶ The draft form does not appear to split the deduction between its two components (i.e., FDII and the GILTI inclusion) and report them in separate areas of Page 1 of Form 1120.
- ▶ States may find that the new deduction amount does not correspond to the state’s effective tax rate and they may want to address this disparity, including by decoupling from the deduction.
- ▶ Might the taxable income limitation operate *differently* for state purposes?

International provisions, Section 250, deduction for GILTI and FDII



- ▶ If the deduction is reported as a Line 29b “special deduction” for federal purposes, the analysis and resulting state impact could be very different in certain states:
 - ▶ For example, **Utah** decouples from “special deductions for dividends received” – but it’s unclear whether GILTI will be considered a dividend for Utah purposes.
- ▶ States may go in any direction – they may decouple from all or just a component of Section 250.
- ▶ Examples:
 - ▶ **New York** decouples only from the FDII component.
 - ▶ **Georgia, Indiana** and **North Dakota** decouple only from the GILTI component.

Qualified property expensing, Sections 168(k) and 179

- ▶ States have a history of decoupling from federal bonus depreciation, and it is expected that such decoupling efforts will continue with these new federal tax law changes which will further exacerbate the differences between federal and state asset basis:
 - ▶ For example, **Pennsylvania** S.B. 1056, enacted June 28, 2018, decouples from 100% bonus depreciation enacted by the TCJA:
 - ▶ For assets placed in service after September 27, 2017, if a deduction for depreciation was included in taxable income, an additional depreciation deduction is allowed until the full amount included has been claimed. The amount of the deduction is equal to the amount calculated under Sections 167 and 168 of the IRC, except Section 168(k) does not apply.
- ▶ It is not “bonus as usual” in the states – in addition to considering whether a state specifically decouples from Section 168(k), taxpayers must *a/so* evaluate the relevant FTI starting point, which is based on general conformity style and date.

Business interest deduction limitation, Section 163(j)

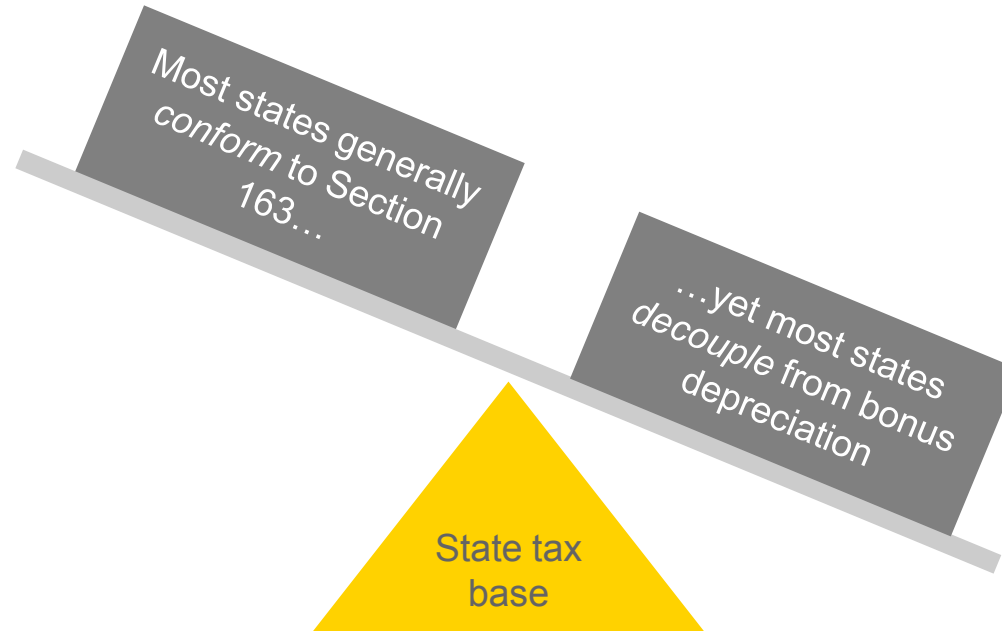
- ▶ Since the new Section 163(j) limitation will be part of the computation of a deduction used to determine FTI, and since most states use FTI as the starting point to determine state taxable income, absent legislative decoupling, the states generally will follow the provision, presumably including its carryforward period:
 - ▶ In addition, the creation of a new carryforward attribute for disallowed interest creates uncertainty as to whether states will apportion it and whether they will conform to the carryover provisions of Section 381 and the ownership change limitations of Section 382.
- ▶ Since most states do not incorporate federal consolidated return concepts into their law, the states might deviate from the federal treatment and seek to determine any limitation at the individual entity level.
- ▶ The intersection of state related-party interest expense addback rules could introduce increased complexity.

Business interest deduction limitation, Section 163(j)

- ▶ State responses to new Section 163(j) vary:
 - ▶ **New Jersey** 2018 N.J. Laws, ch. 48 (AB 4202 / SB 2746), enacted July 1, 2018, conforms New Jersey corporation business tax (CBT) law to Section 163(j) of the IRC but requires that it apply for CBT purposes on a “pro rata” basis, including intercompany interest already required to be added back to entire net income (ENI):
 - ▶ The law does not define “pro rata.”
 - ▶ **Georgia** HB 918, enacted March 2, 2018, conforms to Section 163(j) of the IRC as of December 21, 2017 – the day before the TCJA was enacted:
 - ▶ This prevents use of international affiliates as a way to reduce Georgia income (reported at the separate entity level).
 - ▶ **Tennessee**, Georgia’s neighboring state and presumed competitor for business, enacted similar legislation and also decoupled from Section 163(j) of the IRC, effective beginning in tax year 2020.

Tax impacts of debt and acquisition of capital assets

Recall that, from a federal policy standpoint, the Section 163(j) business interest deduction limitation and full expensing of qualified property under Section 168(k) go hand-in-hand. However, in the state tax base an imbalance may exist.

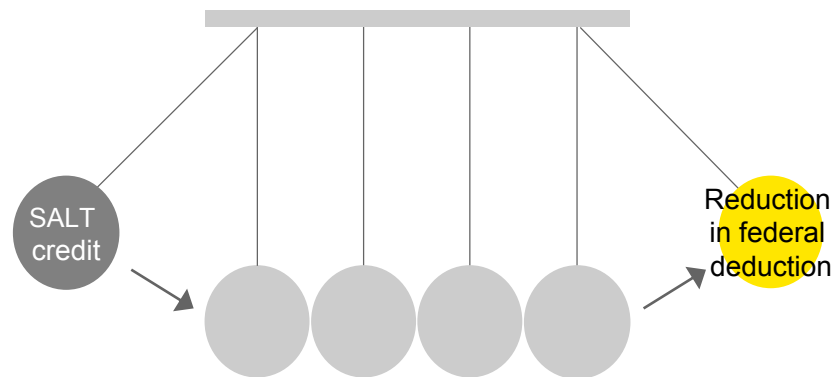


SALT deduction limitation for individuals, Section 164

- ▶ Some state governmental leaders, including those in **California, Connecticut, New Jersey, New York,** and **Oregon**, have enacted or taken steps to restructure their tax laws to reduce the impact of the capped SALT deduction on their residents and even challenging the federal government’s ability to impose any limitation in court:
 - ▶ For example:
 - ▶ **Connecticut** enacted a PTE tax for which owners receive a tax credit against their own tax Connecticut tax obligations.
 - ▶ **New York's** employer compensation expense tax, an employer elective entity-level payroll tax for which employees may claim a credit against their New York personal income tax liabilities.
 - ▶ **Connecticut, New York, and New Jersey** enacted state and local sponsored “charities.”
 - ▶ **New York**, joined by **Connecticut, Maryland,** and **New Jersey**, sued the Trump Administration:
 - ▶ Violates Due Process and 10th Amendment (state sovereignty)
 - ▶ *New York, et al. v. Mnuchin, et al.*, Civ. Act. 18-6427 (So. Dist. N.Y. July 17, 2018)
 - ▶ While attention on the SALT deduction limitation is focused in the “high individual income tax rate” states, challenges are anticipated from taxpayers throughout the US (e.g., **Texas**, which has high property taxes).

SALT deduction limitation for individuals, Section 164

- ▶ Recently proposed Treasury Regulations intend to prevent states from circumventing the \$10,000 cap on the federal SALT deduction limitation through state and local sponsored charities:
- ▶ Under these proposed Treasury Regulations, a taxpayer that (1) makes a payment or transfers property to or for the use of a Section 170(c) entity (e.g., charity) and (2) receives or expects to receive a SALT credit in return **must reduce the charitable contribution deduction he or she claims to reflect the “quid pro quo” received.**



Federal charitable contribution deduction, *quid pro quo*

PTE deduction for individuals, Section 199A

- ▶ Section 199A provides that the deduction is not allowed in computing federal “**adjusted gross income**” (AGI) but instead is allowed as a deduction in reducing federal “**taxable income**”:
 - ▶ This was intended by Congress to allow the PTE deduction without affecting an individual taxpayer’s standard deduction.
- ▶ Only six states* begin their tax base with federal “taxable income”:
 - ▶ Of these six states:
 - ▶ **Colorado** and **North Dakota** have adopted Section 199A by virtue of their rolling IRC conformity, with no relevant legislative modifications proposed thus far.
 - ▶ **Oregon** recently enacted an addition to FTI for the amount allowable as a deduction under Section 199A, thus negating the effect of the state’s general rolling IRC conformity.
 - ▶ **Idaho** updated its fixed-date IRC conformity and now adopts the IRC in effect on January 1, 2018, thus conforming to Section 199A unless decoupling legislation is enacted.
 - ▶ **Minnesota** and **South Carolina** conform to the IRC on a pre-TCJA fixed-date basis and have yet to enact TCJA-conforming legislation.
 - ▶ **Iowa** changed its tax law to provide for a modified Section 199A deduction ... “we have a lot of farmers ...”

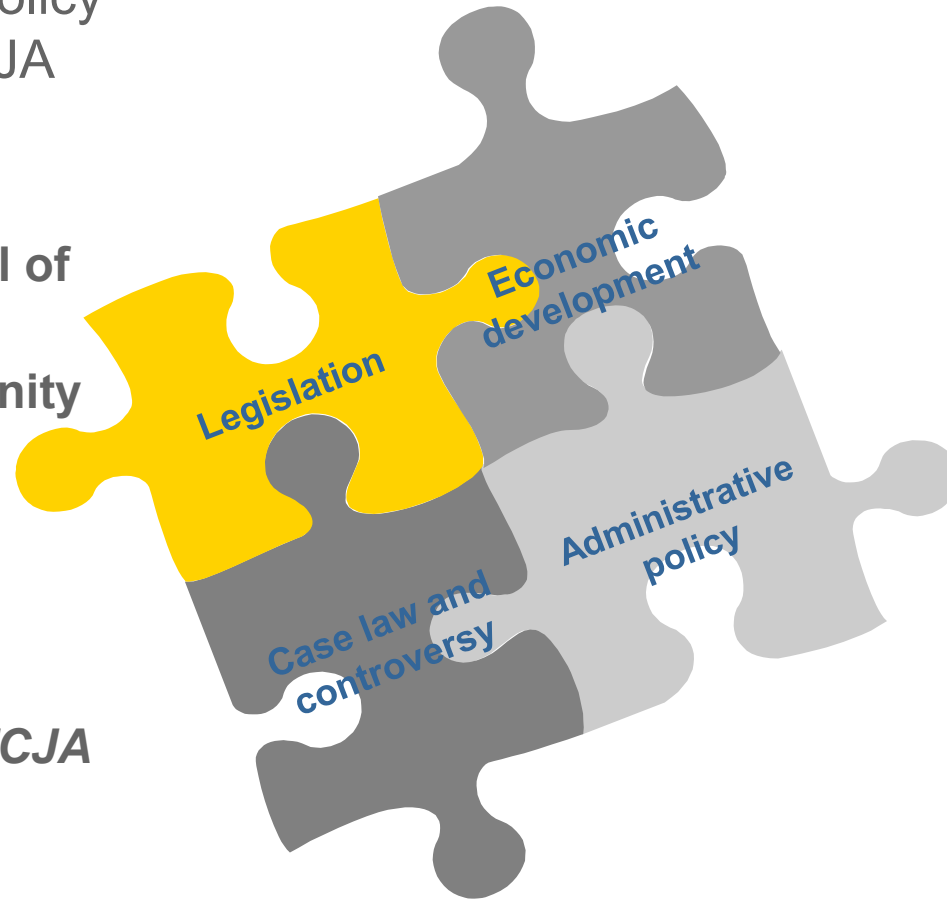
* According to a [schedule](#) prepared by the Federation of Tax Administrators (FTA), as of January 1, 2018. **Vermont** was originally on the FTA list but changed its state tax base starting point to AGI in 2018.

Piecing together the state impacts of federal tax reform

The various forces within the state tax policy environment will continue to react to TCJA provisions, including:


- ▶ Section 172 **NOL deduction**
- ▶ Section 118 **contributions to the capital of a corporation**
- ▶ Sections 1400Z-1 and 1400Z-2 **Opportunity Zone program**
- ▶ Other international provisions
- ▶ Treasury Regulations on such provisions

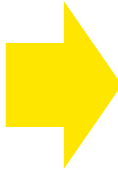
There are possible US Constitutional limitations on state conformity to many TCJA provisions



US tax reform and the new tax compliance burden, scaling up

Tax year 2017

- ▶ Technical corrections issued on various provisions 
- ▶ Section 965 Transition Tax
 - ▶ Reported on 2017 return with complex “with and without” computations required
 - ▶ Need for E&P and tax pool scrub
 - ▶ Incremental state forms and disclosures
- ▶ State implications of transition tax and e-filing will be a challenge due to lack of states’ readiness
- ▶ Qualified property expensing
- ▶ Capture final permanent credits and deductions, method opportunities and attribute planning



Tax year 2018

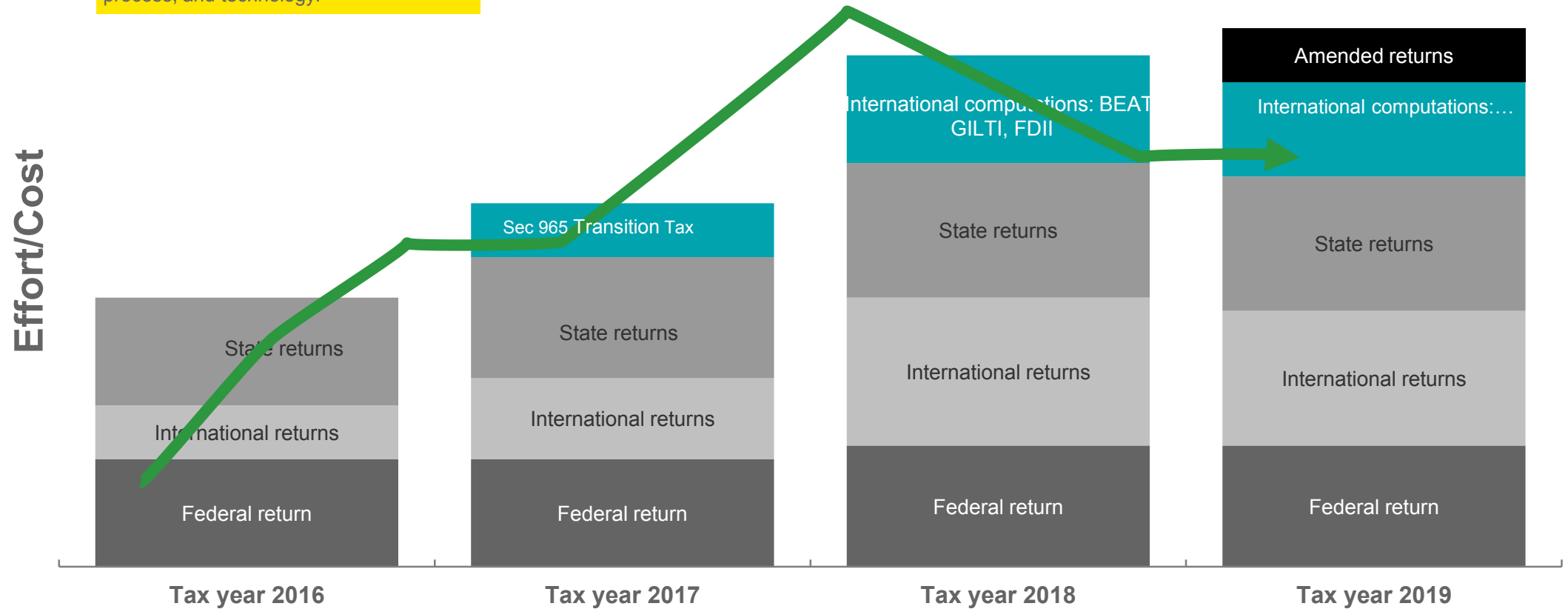


- ▶ Full impact of **119 TCJA provisions** hits federal and state returns with significant work required to implement
 - ▶ International provisions
 - ▶ Pass through deduction
 - ▶ Interest expense deduction limitations
 - ▶ Executive compensation limitations
 - ▶ Significant new disclosures and partnership footnote requirements
- ▶ IRS has **450+ forms** and instructions to create/update to address the new provisions
 - ▶ Expected timing of guidance and forms will be late in the tax compliance cycle, creating an **abbreviated timeline** to review and digest
- ▶ Potential incremental state forms and disclosures
- ▶ Tracking of federal and state legislative changes and administrative guidance

The cost of compliance and defining a “new normal”

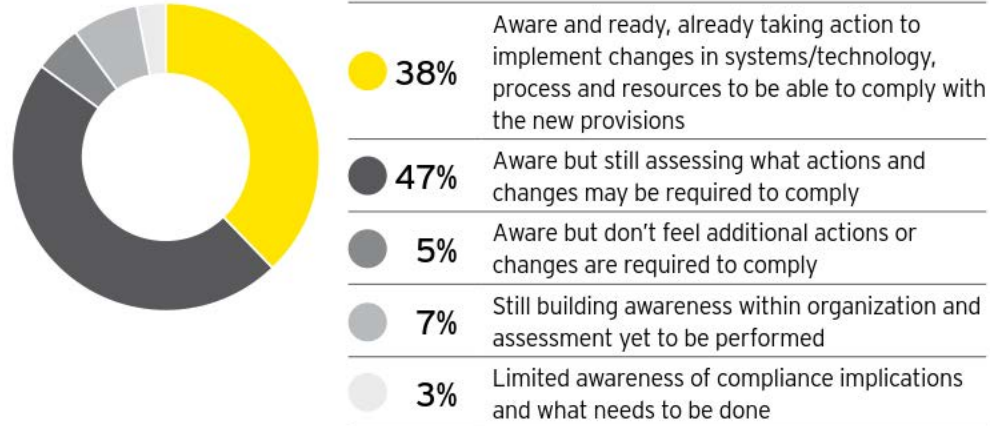
The “new normal” will be influenced by actions taken now to implement and operationalize tax reform via people, process, and technology.

Tax compliance

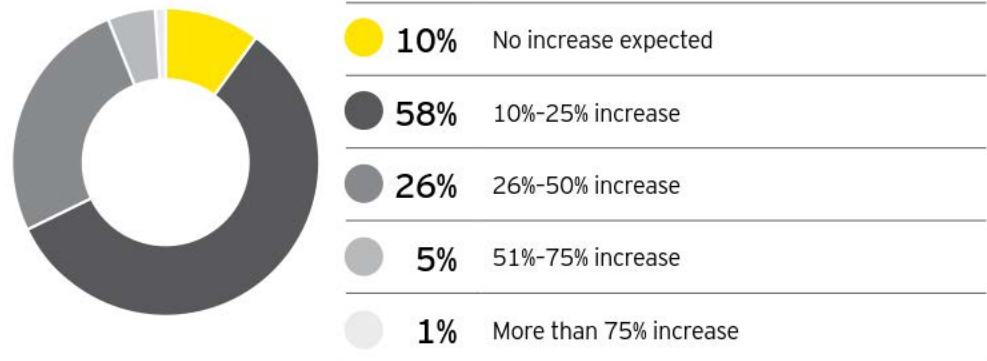


Recent poll of more than 2200 executives

Where is your organization currently on level of awareness and readiness for the impact of US tax reform on your tax compliance process?



How much do you expect your overall compliance costs/effort to increase over the next several years as a result of US tax reform?



Poll (continued)

What is your primary area of concern around complying with new tax reform requirements?



- 32% Enough resources
- 26% Ability to get required data
- 23% Adequate training for resources
- 15% Technology and process changes
- 4% Communicating changes to C-suite

What is your primary area of concern for 2017 state income tax compliance?



- 61% Reacting timely to changing state laws, including transition tax conformity
- 18% Reconciliation with federal taxable income including transition tax
- 12% Tax return software/e-filing
- 9% None of the above

What, if any, Section 965 elections do you intend to make?



- 41% Section 965(h) – pay net §965 toll tax liability in installments (over eight years)
- 11% Section 965(n) – not to apply NOL in inclusion year
- 6% Section 965(i) – for shareholder of S corporation to defer payment of net toll tax until triggering event
- 3% Section 965(m) – for REIT to spread toll tax income inclusion over eight years
- 39% None of the above

Which federal change will require the most compliance effort from your company?



- 36% Global intangible low-taxed income (GILTI)/ Foreign derived intangible income (FDII) calculations
- 27% One-time transition tax
- 15% Meals and entertainment
- 14% Other provisions
- 8% Base Erosion Anti-Abuse Tax (BEAT)

State and local tax developments and ballot measures

Select state and local tax developments

New Jersey CBT changes

- ▶ AB 4202/SB 2746 ((2018 N.J. Laws ch. 48) enacted July 1, 2018): Sweeping changes to the CBT, including:
 - ▶ Mandates water's edge combined reporting effective January 1, 2019 (with taxpayer option for worldwide or affiliated group filing)
 - ▶ Apportionment calculated using "Joyce method" generally
 - ▶ Intercompany gains/losses are generally deferred
 - ▶ Overhauls NOL carryforward and credit carryforward rules
 - ▶ Combined group dividends are eliminated
 - ▶ Imposes temporary surtax beginning January 1, 2018
 - ▶ NJ has second highest corporate tax rate in the US (after Iowa)
 - ▶ Adopts market-based sourcing for services, effective January 1, 2019
 - ▶ Adjusts DRD for dividends from 80% or more owned subsidiaries, effective for tax years beginning after December 31, 2016
 - ▶ Decouples CBT from certain parts of TCJA

Select state and local tax developments

New Jersey CBT – technical corrections and substantive changes to the CBT enacted in July

- ▶ AB 4262 – Governor conditionally vetoed, suggested technical corrections and substantive changes to AB 4202
 - ▶ Governor’s proposed changes being considered by the legislature
 - ▶ Timing for consideration of changes – mid- to late-September, October
- ▶ Technical corrections, if approved, would modify provisions related to:
 - ▶ Intercompany interest and intangible expense addback rules
 - ▶ Calculating NJ allocation, as applied to deemed dividends under IRC §965
 - ▶ NOLs and pre-allocated NOLs (PNOLs)
 - ▶ Deferred tax assets
 - ▶ Mandatory combined reporting
 - ▶ Surtax

Select state and local tax developments

New Jersey CBT – technical corrections and substantive changes to the CBT enacted in July

- ▶ Substantive changes, if approved, would:
 - ▶ Reverse the changes to the NOL and DRD ordering rules in AB 4202
 - ▶ Expand the definition of “combined group” to include “all business entities” in place of “corporations”
 - ▶ Apply the “*Finnigan*” method to all combined filing options
 - ▶ Revise the new water’s edge combined filing rules, includes CFCs and tax havens – new meaning to “water’s edge”
 - ▶ Apply the minimum tax of \$2,000 to each member of a combined group
 - ▶ Bar taxpayers that don’t renew worldwide or affiliated group elections in expiration year from making an election for three tax years
 - ▶ Empower the Director of the Division of Taxation to include income/factors of non-group members to more accurately reflect income
 - ▶ Change the effective date of combined filing and market-based sourcing to tax years ending on or after July 31, 2019

Select state and local tax developments

- ▶ **Alabama** – Amnesty program ends September 30, 2018; pay delinquent taxes in exchange for waiver of interest and penalties, limited lookback period
- ▶ **San Francisco, CA** – Proposition C (passed by voters on June 5, 2018) – Effective January 1, 2019, imposes new gross receipts tax on certain commercial real estate leases; 1% rate for “warehouse space” gross receipts and 3.5% rate for all other “commercial space”
- ▶ **California** – AB 1838 (enacted June 28, 2018) – Prohibits local governments from imposing a tax, fee or assessment on groceries, including soda; effective June 28, 2018, sunsets January 1, 2031
- ▶ **Colorado** – HB 1185 (enacted June 4, 2018) – Adopts market-based sourcing for sales from intangible property and services starting in 2019

Select state and local tax developments

- ▶ **Connecticut** – SB 11 (enacted May 31, 2018), among other changes:
 - ▶ Imposes 6.99% income tax on PTEs and provides a credit to offset tax at personal and corporate income tax level, effective tax year 2018
 - ▶ Allows municipalities to provide a property tax credit to eligible taxpayers who make voluntary payments to municipally approved “community supporting organizations”
 - ▶ Requires individuals and corporations to apportion federal asset expensing deduction over five years
 - ▶ In calculating DRD under corporate business tax, expenses related to dividends equal 5% of all dividends received by a company during an income year
 - ▶ Decouples from the business expense interest limitation in IRC §163(j)
- ▶ **Louisiana** – HB 10 (3rd Extraordinary Session, enacted June 24, 2018) – Extends “Clean Penny” additional sales and use tax but at a reduced rate of 0.45%; makes uniform various sales and use tax exemptions and exclusions; effective July 1, 2018 through June 30, 2025
- ▶ **Louisiana** – HB 13 (2nd Extraordinary Session, enacted June 12, 2018) – Clarifies that the limits on corporate income tax exclusions and deductions enacted in 2015 apply to taxable years beginning during calendar years 2015, 2016 and 2017, regardless of the date on which the original or any amended return for these periods is filed

Select state and local tax developments

- ▶ **Massachusetts** – HB 4820 (enacted August 9, 2018) – Establishes tax expenditure commission to evaluate and report on administration, effectiveness and fiscal impact of tax expenditures
- ▶ **Missouri** – SB 884 (enacted June 1, 2018)
 - ▶ Mandates use of single sales factor formula (except for unique industries such as transportation, financial services, etc.); eliminates equally weighted three-factor apportionment method and historic partly within/partly without single sales factor method
 - ▶ Reduces corporate income tax rate to 4% (from 6.25%) starting in 2020
 - ▶ Retains 50% federal income tax deduction
 - ▶ Eliminates intercompany transactions between corporations that file a consolidated Missouri income tax return
- ▶ **Missouri** – HB 2540 (enacted July 12, 2018)
 - ▶ Reduces top individual income tax rate to 5.4% (from 5.9%) for tax years beginning on or after January 1, 2019, with additional reductions if revenue targets are met
 - ▶ Permits business income deduction to increase in 5 percentage point increments each year a revenue trigger is met, up to max of 20% (from 25%)
 - ▶ Eliminates personal and dependent exemptions
 - ▶ Phases out federal income tax deduction

Legislative developments

- ▶ **North Carolina** – SB 99 (enacted June 12, 2018)
 - ▶ Amends various corporate income/franchise tax provisions, including subjecting to franchise tax partnerships electing to be treated as corporations for federal income tax purposes
 - ▶ Updates IRC conformity date to February 9, 2018, but decouples from certain TCJA related provisions, including the Transition Tax, GILTI, FDII
 - ▶ Provides automatic extension to file income/franchise tax return for those granted automatic federal extension
 - ▶ Clarifies notification and filing requirements regarding amended federal returns
 - ▶ Amends various sales and use tax provisions, including amending the definition of “qualifying datacenter” and direct pay permit provisions
 - ▶ Clarifies that non-North Carolina captive insurance companies are not subject to captive insurance, corporate income, franchise, or gross premiums tax
- ▶ **Rhode Island** – HB 7200Aaa (enacted June 22, 2018) – Expands sales and use tax base, including to vendor-hosted prewritten computer software, effective October 1, 2018, among other changes

Select state and local tax developments

- ▶ **Illinois** – *Labell v. City of Chicago* (Cook Cnty. Cir. Ct. May 24, 2018) – Upheld Chicago’s 9% amusement tax on internet-based streaming services
- ▶ **Maryland** – *Staples, Inc.* (Md. Ct. Special App. August 9, 2018) (unreported) – Court of Special Appeals affirmed lower court’s ruling that enterprise dependency existed and that the out-of-state corporations were not separate business entities from in-state affiliated companies, were part of a unitary business, and thus had nexus with Maryland
 - ▶ Affirmed Comptroller’s attribution of the in-state company’s apportionment factor to the out-of-state affiliated companies that received the interest and royalties
- ▶ **Minnesota** – *General Mills, Inc.* and *IBM* (Minn. Tax Ct. August 17, 2018) – In computing R&D credit the state “base amount” must use federal gross receipts in the denominator of the fixed-base percentage; state law incorporated federal minimum base amount but did not incorporate federal election of alternative simplified credit
- ▶ **Minnesota** – *Associated Bank, N.A.* (Minn. S. Ct. July 5, 2018) – *HMN Financial* does not preclude the state from applying alternative apportionment formula when the standard apportionment formula did not fairly reflect income

Select state and local tax developments

- ▶ **Oregon** – *Capital One Auto Finance, Inc.* (Or. S.Ct. August 9, 2018) – Banks’ in-state activities created an economic presence sufficient to established nexus, no physical presence required for corporate income tax nexus
- ▶ **Pennsylvania** – *Williams v. City of Philadelphia* (Pa. S.Ct. July 16, 2018) – Philadelphia’s soda tax is constitutional, not preempted by state
- ▶ **Pennsylvania** – *Nextel Comm. of the Mid-Atlantic, Inc.* (U.S. S.Ct. June 11, 2018) (cert. denied) – Denial of certiorari leaves in place Pennsylvania Supreme Court ruling that as applied to Nextel, the state’s net loss carryover is unconstitutional
 - ▶ Corporate Tax Bulletin 2018-02 (May 10, 2018) – Taxpayers may use flat dollar cap on net loss carryforwards for taxable years beginning before January 1, 2017
- ▶ **Wisconsin** – *Tetra Tech EC, Inc.* (Wis. S.Ct. June 26, 2018) – State Supreme Court ended its practice of deferring to administrative agencies’ conclusions of law; it will review such conclusions de novo, giving “due weight” to experience, technical competence and specialized knowledge of administrative agency

Select ballot measures certified for the November 6, 2018 election

- ▶ **Arizona:** Proposition 126 – prohibit new, increased transaction taxes on services
- ▶ **California:** Proposition 6 – Repeal 2017 gas tax increase
- ▶ **San Francisco, CA:** Proposition C – Additional tax (ranging between 0.175% and 0.69%) on gross receipts above \$50m, with some exceptions; would help fund homeless services
- ▶ **San Francisco, CA:** Proposition D – Expand “Engaging in Business Within the City” provision by adding a \$500,000 economic threshold
- ▶ **Colorado:** Amendment 73 – Increase the corporate income tax rate from 4.63% to 6.00%; increase individual income tax on those making \$150,000 or more
- ▶ **Colorado:** Initiative #153 – Increase the state sales and use tax from 2.9% to 3.52% for a 20-year period starting in 2019
- ▶ **Florida:** Amendment 5 – 2/3rds legislative vote required to enact a tax or fee increase
- ▶ **Georgia:** Sales Tax for Educational Purposes Referendum – Certain school districts would be allowed to call for a referendum to levy a sales tax for educational purposes
- ▶ **Hawaii:** State Bill 2922 – Legislature authorized to impose a surcharge on investment real property

Select ballot measures certified for the November 6, 2018 election

- ▶ **Maine:** Question 1 – Create a payroll tax and non-wage income tax to fund the Universal Home Care Program
- ▶ **Missouri:** Proposition D – Gas tax increase
- ▶ **Montana:** Initiative I-185 – Increase tax on tobacco products
- ▶ **Nevada:** Question 4 – Require the Nevada Legislature to exempt medical equipment from sales tax
- ▶ **North Carolina:** North Carolina Income Tax Cap Amendment – Amend the state Constitution to lower the maximum allowable income tax rate that could be imposed on individuals from 10% to 7%
- ▶ **Oregon:** Measure 103 – Prohibit state and local governments from imposing any tax, fee or other assessment on groceries
- ▶ **South Dakota:** Measure 25 – Increase the excise tax on cigarettes
- ▶ **Utah:** Proposition 3 – Increase the state sales and use tax from 4.70% to 4.85% to pay for Medicaid expansion
- ▶ **Washington:** Initiative 1631 – Establish a carbon emissions fee of \$15 per metric ton of carbon, starting in 2020
- ▶ **Washington:** Initiative 1634 – Prohibit local governments from imposing any new taxes on groceries