State and Local Tax Considerations Under Current Federal Tax Law

TUESDAY, MAY 7, 2019, 1:00-2:50 pm Eastern

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By Michael J. Cataldo and Jeffrey S. Reed

Agenda

- Introduction / Conformity
- International Provisions
- Business Tax Reform Provisions
- $10,000 SALT Deduction Limitation Workarounds
- Other TCJA Provisions and State Conformity Issues
- Questions

Introduction to Tax Cuts and Jobs Act

- Transition tax under IRC section 965
- Global Intangible Low-Taxed Income (GILTI) under IRC section 951A
- Interest Expense Limitation under IRC section 162(j)
- Expensing under IRC section 168(k)
- Like-Kind Exchanges
- Net Operating Losses
- Domestic and Foreign Dividends Received Deductions

State Conformity

- States define income by reference to the IRC in several different ways:
  - Static – conform as of certain date.
  - Rolling – conform to IRC changes as made.
  - Selective – incorporate static versions of certain sections.
  - Choice – example, Michigan allows either 1/1/2018 IRC or current version.
- Consequences
  - If static, need legislation to incorporate new provisions.
  - If rolling, need legislation if want to decouple from IRC.
- Line 28 or Line 30 of Form 1120 (take into account NOLs and special deductions)

Impact on State Filing Methods

Separate company reporting

- Starting point federal taxable income
- Line 28 or line 30 of Form 1120

Combined reporting

- Composition of unitary group
- Water's edge or worldwide
- Federal consolidated return rules different than state combined reporting rules.

International Provisions

Transition Tax

Income inclusion under IRC section 965

- US shareholders must pay a one-time transition tax on accumulated untaxed foreign earnings of certain controlled foreign corporations.
- Transition tax calculated separately from federal taxable income. (IRS Publication 5292).
- Increase in Subpart F income under IRC section 952.
- Reduction for certain foreign affiliates with negative E&P.
- Deduction under 965(c).

Transition Tax

Included in state tax base

- Conformity to IRC
- State legislation

State-level deduction

- Deduction under IRC section 965(c)
- Foreign-source income subtraction or dividends received deduction

Combined reporting

- Prior year worldwide combined returns included foreign earnings
- DRD or elimination
- Different federal consolidated and state combined group composition

Transition Tax

Income Classification

- Business or nonbusiness income

Apportionment of Business Income

- Deemed amounts included in sales factor?
- How are they assigned (COP, market-based, excluded)?
- Inclusion of foreign subsidiary factors?
- Distortion – multi-year factor relief?

Transition Tax

Actual repatriation

- 100% DRD under IRC section 245A
  - *Kraft* foreign commerce clause issues
- Exclusion of previously taxed income
- State specific DRD or foreign income exclusion
- Foreign investment interest offset
- Business/nonbusiness income classification
- Apportionment

Transition Tax

- Illinois – Income included in tax base; foreign dividend subtraction excludes portion of the income.
- California – Income excluded from worldwide combined returns. No impact on water's edge inclusion ratio which uses Subpart F income as defined in IRC section 952.
- Oregon – Income included in tax base; no IRC section 965(c) deduction; 70-80% state-level DRD. Special exclusion for amounts previously taxed in combined return from tax havens.
- Florida – Income excluded because it does not flow into federal taxable income.
- New Jersey – Income included in the tax base; partial dividends received deduction; exclusion if subsidiary paid New Jersey tax on same earnings; special allocation formula that is the lesser of the three-year average 2014 through 2016 allocation factor or 3.5%.
- New York – Income is considered gross exempt CFC income excluded from tax base.
- Pennsylvania – Income included in tax base; state-level DRD.

Global Intangible Low-Taxed Income (GILTI)

- What the reform does
  - Basic idea: tax income earned by foreign subsidiaries of US corporations. This way it does not escape taxation. But tax it at a lower rate.
- Computation
  - IRC section 951A: taxes income earned by foreign subsidiaries, using assumptions about how much income is intangible.
  - IRC section 250(a)(1)(B): provides a deduction that lowers the tax rate.
  - Credits: corporations can claim a credit for 80% of tax paid to foreign jurisdictions on GILTI income.

GILTI - State Tax Treatment of the Income

- Conceptual Issues
  - States have to address the income inclusion and the deduction.
  - If the income is included, but not the deduction (it is a special deduction), at cross-purposes with federal tax treatment.
  - If the income is excluded, but the deduction is granted, taxpayers receive a windfall compared to federal income tax treatment.
  - If credit not granted, may be taxing something that is not deemed “GILTI” for federal income tax purposes.
  - Should states be taxing this income at all? Unitary?
- Majority approach
  - Exclude GILTI – 95% or more (mechanics can vary from state to state).

GILTI – New Jersey

- New Jersey approach
  - Include the income as computed under IRC 951A.
  - Adopts the special deduction under IRC 250(a)(1)(B).
  - Cannot take into account foreign tax credits.
  - Cannot take the special deduction unless income inclusion.
  - Apportionment – ratio of NJ GDP / total US GDP in which the taxpayer has economic nexus. 3.1% apportionment if nexus in all 50 states.
  - Mechanism to prevent double-counting (tax on GILTI and also if the entity is taxed in a worldwide combined return).

GILTI – New York

- New York approach
  - Include the income as computed under IRC 951A.
  - Adopts the special deduction under IRC 250(a)(1)(B).
  - Apportionment: net GILTI included in the denominator and not in the numerator.

Business Tax Reform Provisions

Interest Deductibility

- IRC section 163(j) interest expense deduction generally limited to 30 percent of federal adjusted gross income.
- Indefinite carryover of unused interest to future years, subject to IRC 381.
- Proposed federal regulations under IRC section 163(j) make calculation on consolidated basis.

Interest Deductibility

Conformity/decoupling issues

- Allocation of disallowed interest expense from federal consolidated return
- Combined reporting – limitation applied on group or by entity?
  - Allocation disallowed interest expense?
  - Siloing of disallowed interest carryover?
- State related party interest expense addback
- Nonbusiness income deduction?
- Apportionment of carryover (which year?)
- Interest income included in state tax base of recipient?

Interest Deductibility

Pennsylvania Corporation Tax Bulletin 2019-03, April 29, 2019:

- Pennsylvania will not impose interest expense deduction limitation for taxpayers included in a federal consolidated return if federal group not subject to interest expense deduction limitation.
- If federal consolidated group has IRC section 163(j) limitation, Pennsylvania taxpayers that are members of the group must determine any 163(j) limitation on a separate company basis.

Interest Deductibility

New Jersey Technical Bulletin 87, April 12, 2019

- follow federal proposed regulations requiring calculation on consolidated basis.
- the federal consolidated group limitation must be allocated among group members.
- Related party addback applied after 163(j) limitation.

Interest Deductibility

Virginia follows IRC section 163(j) and allows a deduction equal to 20% of the amount of disallowed interest.

Domestic Dividends Received Deduction

Percent Ownership	Deduction % Old Rules	Deduction % New Rules
Less than 20%	70%	50%
20% up to 80%	80%	65%
80% or more	100%	100%

Foreign Dividends Received Deduction

IRC section 245A permits a 100% DRD for foreign source portion of dividends received from certain foreign subsidiaries.

Net Operating Losses – TCJA Changes

- Prior Rules
  - Carryback two years.
  - Carryforward 20 years.
  - No NOL limitations.
- TCJA
  - No carryback.
  - Indefinite carryforward.
  - Limitation of 80% of taxable income.
- State approaches
  - Most states eliminated carryback, carryforwards all over the map (5 year to unlimited carryforward, depending on state).

Overview of Other TCJA Changes

- SALT Deduction Cap
- Deductibility of Fines and Penalties (IRC Section 162(f))
- Expensing under IRC Section 168(k)
- Like-Kind Exchanges
- 20% Deduction for Certain PTE Business Income (IRC Section 199A)
- Partnership Technical Terminations
- Accounting Method Changes

$10,000 SALT Deduction Limitation

$10,000 SALT Deduction Limitation

- Overview
  - Pre-TCJA: taxpayers could deduct state and local taxes (income taxes, property taxes) on federal income tax returns.
  - Post-TCJA: $10,000 limitation. Has large impact for some high-income earners in states with significant income and property taxes.
- Strong political opposition from some states
  - Attacked as “economic assault” by NY’s governor and strongly opposed by several state governors.
  - Led to litigation and the proposal of several workarounds.

Lawsuit Challenging the Limitation

- Summary
  - CT, MD, NJ, NY are challenging the limitation in the SDNY.
  - Argument 1: the limitation interferes with powers reserved to the states by the 10th Amendment (e.g., the ability to set their own tax policies).
  - Argument 2: conflicts with enactment of the 16th Amendment (violates the terms of the deal – states allowed federal tradeoff in exchange for deduction).
  - Argument 3: coerces states to change their tax policies, without giving the states a seat at the table.
  - All federalism-based arguments.

Workaround 1: Charitable Contribution

- Idea
  - Allow taxpayers to donate to a state charity.
  - A credit is then allowed against state income or local property tax.
  - For federal income tax purposes, still can deduction the full amount because it is a charitable contribution not subject to a $10,000 limitation.
  - New York, New Jersey, Connecticut.
- IRS shuts this down
  - Proposed regulations state that the federal charitable contribution deduction must be reduced by any amount that resulted in a state / local credit, unless the credit is 15% or less of the donation amount.

Workaround 2: Payroll Tax

- Idea
  - NY experimented with this. Employer Compensation Expense Tax.
  - Idea is that employer can deduct taxes, but employees cannot.
  - So shift state and local income tax from employee to employer.
  - Genesis of workaround is a law and economics professor.
  - Complicated mechanics for doing this (employee paid less, but in same place economically, credit mechanism, etc.). Employer must elect in to this.
  - Lots of issues – what about nonresident employees who would be paid less but would not receive credit in home state?
  - Few employers made the election.

Workaround 3: Pass-through Entity Level Tax

- Idea
  - Impose tax at the entity level, give pass-through owner a personal income tax credit.
  - So state tax shifted from partner to partnership (partnership can deduct tax for federal income tax purposes without limitation).
  - Connecticut and Wisconsin. CT applies to most PTE, WI opt-in.
  - CT credit – roughly 93% of proportionate liability. Can be applied against corporate or personal income tax. Refundable.
  - Other states considering this (NY discussion draft for state-level UBT).
  - Largest issue – what about nonresident partners? Can they claim credit in home state?

Other Workarounds

- Planning with Trusts
- MOVE!!!!
- High-tax states anticipating lots of high net worth individuals will move to FL, TX, NV.
- Residency audits.
- Other ideas?

Other Issues

Deductibility of Fines and Penalties (IRC Section 162(f))

- TCJA Reform and State Tax Issue
  - Under TCJA, new 162(f) disallows a deduction for amounts paid or incurred in relation to the violation of any law or investigation or inquiry by such government or entity into potential violation of the law.
  - 6050X provides for a disclosure requirement.
  - There are safe harbors (payment is restitution and can show that you have come into compliance).
  - State issue: if a payment is made that would be nondeductible under new 162(f), but a state has not adopted new 162(f), still deductible?

Expensing under IRC Section 168(k)

- TCJA Reform
  - TCJA allows 100% bonus expensing for certain MACRS depreciable property with a recovery period of 20 years or less.
  - Property must be “new to you.”
  - Bonus depreciation gradually phased out between 2023 – 2026.
- State Issue
  - Many states will not allow bonus depreciation.
  - Will have different federal and state depreciation.

Opportunity Zones

- TCJA reform
  - Unrealized capital gains can be invested in funds that invest in “opportunity zones,” which are economically distressed areas within the United States. Provisions contained in new IRC 1400Z-1 and 1400Z-2.
  - Investors can defer or eliminate capital gains.
- State Tax Issue
  - “Rolling conformity” states would allow for analogous state tax benefit.
  - A few states have opted out (HI and NC)
  - Arkansas has limited conformity only to investments in Arkansas opportunity zones (so Arkansas resident would not receive benefit for non-Arkansas opportunity zone fund). *Cutler* issue.

Like-Kind Exchanges

- IRC section 1031 narrowed to cover only real property.
  - Potential state-only 1031 treatment for eligible non-real property
  - California annual disclosure of 1031 exchanges for out-of-state property

Repeal of Partnership Technical Terminations

- Technical termination if a sale or exchange of 50% or more of the total interest in partnership capital or profits within a twelve month period.
- Assets and liabilities of the old partnership are deemed contributed into a new partnership in exchange for an interest which is subsequently distributed to the purchasing partners and other remaining partners.
- The new partnership would need to make new entity-level elections, would not be required to use the accounting method of the old partnership, and would need to depreciate any assets contributed from the old partnership as “new” assets.
- Many local real property transfer taxes are imposed on technical terminations of partnerships holding real property.

Accounting Method Changes

- The $5 million threshold for eligibility to use cash method by corporations increased to $25 million.

20% Deduction for Certain Business Income (IRC Section 199A)

- Applicable to pass-through entities
- Certain services businesses ineligible for deduction
    - Phase out based on taxable income
    - Limits applied at partner, member, or shareholder level

Questions

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