Green Hasson Janks &
State & Local Tax Implications of Tax Reform

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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

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Corporate Tax Reform

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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 constraints.
- Taxpayers must separately track, monitor, and implement state modifications to federal provisions.

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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)

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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.

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Business Tax Reform Key Provisions (cont.)

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.

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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: States are unlikely to conform to this deduction.

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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.

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International Tax Reform Key Provisions (cont.)

- **Repatriation Transition Tax**:
  - Accumulated foreign earnings held by CFCs of a U.S. 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.

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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)?

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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."

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International Tax Reform Key Provisions (cont.)

- **Global Intangible Low-Taxed Income (GILTI)**: tax on a U.S. 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).

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International Tax Reform Key Provisions (cont.)

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

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International Tax Reform Key Provisions (cont.)

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.

International Tax Reform Key Provisions (cont.)

- **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.

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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 mitigating impact 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.

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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.

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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.
- **Hawaii—**Conforms to IRC as amended through 2/9/18 for tax years beginning after 2017
- **Idaho**—Adopted RTT, but disallows 965(c) deduction. For 2018 tax year, adopts IRC as of 1/1/18, but disallows 250 deduction.
- **Indiana—**Conforms to IRC as amended in effect on 2/11/18 and effective retroactive to 1/1/16
- **Iowa—**For tax years beginning 2019, IA adopts IRC as in effect on 3/24/18. For tax years beginning on or after 1/1/20, IA adopts IRC as amended (rolling conformity)
- **Maine—**Conforms to IRC as amended as of 3/23/18
- **Michigan—**Adopts IRC effective 1/1/18 for MI corporate income tax and MI Business tax. For both taxes, taxpayer can elect to use IRC in effect for the tax year

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Legislative Developments (cont.)

- **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.
- **South Carolina—**Conforms to IRC as amended through 2/9/18
- **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.
- **Vermont—**Adopts IRC as in effect through 12/31/17 for taxable years beginning on or after 1/1/17
- **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.

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Reporting Method Updates

- Kentucky requires water's-edge combined reporting for unitary groups effective January 1, 2019
- New Jersey requires water's-edge combined reporting for unitary groups effective January 1, 2019

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Sales Factor Updates

- DE phasing in Single-Sales factor through 1/1/20
- KY Single-Sales factor effective 1/1/18
- MO Single-Sales factor only effective 1/1/20 (previously 3-factor option)
- NM phasing in Single-Sales factor through 1/1/18 for manufacturers
- NC phasing in Single-Sales factor through 1/1/18
- ND may elect Single-Sales factor for tax years beginning 1/1/19

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Sourcing of Receipts Updates

- CO market-based sourcing effective 1/1/19
- MO market-based sourcing effective 1/1/20
- MT market-based sourcing effective 1/1/18
- NJ market-based sourcing effective 1/1/19
- OR market-based sourcing effective 1/1/18

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Individual Tax Reform

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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.
  - California: closest connection vs. 183-day test.
  - New York State/City: domicile vs. 183-day test.

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Repeal of SALT Deduction: State Workarounds *Payroll Tax*

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.

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Repeal of SALT Deduction: State Workarounds
Pass-through Entity Tax

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*.

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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 heath 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 (enacted)
  - Authorizes localities to create charitable funds that give donors property tax credits of up to 90% of their contributions.
- Other Proposals:
  - California
  - Maryland
  - Illinois

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Repeal of SALT Deduction: State Workarounds
Charitable Contributions in Lieu of State Income Tax (cont.)

- IRS Released Proposed Regulations Aimed to Reduce Charitable Contribution Deduction
  - If the taxpayer receives or expects to receive a state or local tax credit in return, the tax credit constitutes a return benefit ("*quid pro quo" rather than "sine qua non")*
  - Contribution claimed as deduction must be reduced by FMV of benefit received of making contribution (or FMV of liability assumed by recipient)
  - Notably, the character of payment is determined at the federal level
- As such, these state proposals will likely not work

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Questions?

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Akash Sehgal leads the Firm's Tax Practice, along with having deep expertise in multistate income and franchise tax, sales and use tax and credits and incentives. He has more than 20 years of tax, and prior to joining Green Hasson Janks in 2012, worked at two Big Four firms in Los Angeles and Seattle.

Akash is also the lead tax partner in the Firm's Food and Beverage Practice and works with a number of beverage manufacturers operating both in California and on a multistate basis.

Akash also leads the Firm's research and development credit outsourcing initiative and works closely with specialized research and development credit firms.

Akash enjoys helping clients grow their businesses and assisting them on complex state and local tax issues related to transactional planning, mergers and acquisitions, general day-to-day consulting and compliance. He has significant experience dealing with state tax issues in California, Oregon, Idaho and Washington and local city taxes including the Los Angeles City Business Tax. He is a frequent speaker for a variety of tax associations including Tax Executive Institute ("TEI") and the Council on State Taxation ("COST").

As head of Green Hasson Janks Great Places to Work Committee, Akash has seen the collaboration between the various groups and people at the firm. His strong desire to help both employees and clients #BeMore has helped to make the Firm a great place to work.

Akash has a Bachelor of Science degree in Accounting from California Polytechnic University, Pomona.

Related Industries and Services

- Practice Leader, Tax Practice
- State and Local Tax Planning and Compliance
- Mergers and Acquisitions
- Manufacturing
- Retail
- Financial Services
- Technology

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Frances Ellington, DBA, CPA, is a leader in the State and Local Tax Practice at Green Hasson Janks with a focus on multistate income and franchise tax, indirect tax, and credits and incentives. Frances assists her clients on state and local tax issues related to tax audit controversy, nexus and reporting requirements, and various state tax planning initiatives. She has more than 10 years of state and local tax experience with Big Four and multinational corporations in Los Angeles and Charlotte, NC.

Prior to joining Green Hasson Janks in 2016, she worked for Fox Entertainment Group where she was part of the Leadership@Fox training program and founded a recognition program for Tax Department employees. During her tenure at Deloitte Tax, LLP from 2009 to 2015, she completed three international rotations in the Hyderabad and New Delhi offices of the firm providing training and development to team members in India. Frances served on the Innovation Committee for the Los Angeles office of Deloitte Tax from 2014 to 2015 and attended the Career Windows Leadership Conference at Deloitte University for high-performing female employees in 2013.

Frances' outside community involvement includes the "Principal for a Day" program of the Los Angeles Chamber of Commerce and serving as a career advocate for Fulfillment Fund Destination College. Previously, Frances spent three years as a member of the Junior League of Los Angeles, where she served on the Public Affairs Committee and helped organize events such as "Day at City Hall" and "Community Leadership Forum." She served a two-year appointment on the City of Santa Monica Audit Subcommittee through June of 2017 where she consulted with the City internal and external auditors on activities of the City and made recommendations to the City Council on audit report findings.

Frances has a Bachelor of Science in Business Administration and a master's in Accounting from the University of North Carolina, Chapel Hill. She is currently a lecturer for the University of North Carolina's Master of Accounting program and has previously taught courses for UCLA Extension, Strafford Publications and The Knowledge Group. She graduated from the Doctorate of Business Administration program at Grenoble Ecole de Management based in Grenoble, France and Northridge, CA. Her research focuses on the volatility of state tax as it relates to income tax reporting methods.

Related Industries and Services

- State and Local Tax Planning and Compliance
- State Tax Controversy
- Mergers and Acquisitions
- Food and Beverage
- Health and Wellness
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