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In this issue of Inside Deloitte, the authors consider the potential state tax issues raised by key elements of the federal corporate income tax reform proposals of President Trump and House Republicans.

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I. Introduction

Most states generally begin the computation of state corporate taxable income with federal taxable income.[1] Therefore, when there are changes to the federal income tax code, states are presented with the choice either to conform to or decouple from the federal changes. As many are aware, the most significant change to the federal income tax code since 1986 may be imminent, including several proposals for sweeping changes to the corporate income tax.

Both President Trump[2] and the House Republican majority[3] have released tax reform proposals. The Trump administration also released an updated one-page outline of a tax reform plan on April 26 that reiterated many of the tax reform proposals Trump made during his presidential campaign, including:

- lowering the top corporate income tax rate to 15 percent;
- applying a 15 percent rate to passthrough entities;
- reforming the international tax rules;[4]
- "eliminating tax breaks for special interests"; and

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[1]*See generally* Ruth Mason, "Delegating Up: State Conformity With the Federal Tax Base," 62 *Duke L.J.* 1267, 1308 (Apr. 2013).

[2]The Trump administration plan refers to policy statements and speeches made during Trump's campaign and the one-page outline released on April 26. Trump Presidential Campaign, "Tax Reform That Will Make America Great Again" [hereinafter Trump Tax Reform]; Trump, Remarks at Detroit Economic Club (Aug. 8, 2016) [hereinafter Trump Remarks]; and Fact Sheet: Donald J. Trump's Pro-Growth Economic Policy Will Create 25 Million Jobs (Sept. 15, 2016) [hereinafter Trump Fact Sheet].

[3]House Republican Tax Reform Tax Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016) [hereinafter House GOP blueprint].

[4]Trump's initial tax platform during the campaign called for maintaining the current worldwide system of taxation and repealing deferral of U.S. tax on active foreign-source income; however, the April 26 outline called for transitioning to a territorial system.

- imposing a one-time tax on foreign accrued profits (a "deemed repatriation"), although the rate was not specified.[5]

The one-page plan omits several details of considerable interest to the tax community, and the Trump administration acknowledged that these details need to be developed. For example, in addressing the question of how the 15 percent rate would apply to passthrough entities, Treasury Secretary Steve Mnuchin stated that "the administration will 'make sure that there are rules in place so that wealthy people can't create passthroughs and use that as a mechanism to avoid paying the tax rate they should be paying on the personal side.'"[6]

The Trump administration and House GOP proposals have important differences, lack several technical details, and include a few specific proposals, such as the border-adjustable tax, that are generating significant controversy. Regardless of the potential headwinds, the current Republican dominance of Washington makes the enactment of significant tax reform this year a distinct possibility.

Given this reality, it is time to evaluate the potential state tax consequences of federal tax reform. The full extent of the state consequences is impossible to predict, especially given uncertainty about what sort of tax reform might eventually pass Congress, but we have enough information to make some general observations regarding potential state tax consequences of the Trump administration plan and House GOP blueprint.

II. Preliminary Considerations: Conformity, Revenue, and Balanced Budgets

Discussion of tax reform must start with threshold considerations of state conformity to the Internal Revenue Code and the state budgetary impact of any federal tax reform. Many states base their calculations of corporate taxable income on federal taxable income and then apply modifications. Accordingly, the federal calculation of taxable income is, in many respects, directly incorporated into state taxable income. States generally conform to the IRC and the calculation of federal taxable income as of a specific date,[7] or have rolling conformity, which automatically updates to the version of the IRC in effect for the current tax year.[8] These states must follow different legislative practices to respond to federal changes in the computation of taxable income. For states that have rolling conformity, the states automatically conform to federal changes and would need to take legislative action to decouple from federal changes. Conversely, states that conform to the IRC definition as of a specific date do not automatically conform to federal changes and would need to take legislative action to conform to federal tax reform changes.

Another issue regarding federal tax reform is that, unlike the federal government, states generally cannot engage in deficit spending.[9] Accordingly, in assessing whether a state should conform to or decouple from any federal reform proposal, the states must assess the potential revenue impact of federal tax reform on the individual state. While both the Trump administration plan and House GOP blueprint claim to be revenue-neutral,[10] these

[5] Jonathan Curry and Luca Gattoni-Celli, "Trump Tax Plan Lacks Details, Sparks Revenue Concerns," *Tax Notes Today*, Apr. 27, 2017 (quoting Saba Ashraf as saying, "Somewhat surprisingly, this plan is even shorter, and contains even less detail, than the plan [President Trump] campaigned on").

[6] *See id.*

[7] *See, e.g.*, Ariz. Rev. Stat. Ann. section 43-102 (Arizona conforms to the version of the IRC as it existed on Jan. 1, 2017, subject to specific exceptions, for all tax years beginning on or after Dec. 31, 2016); Cal. Rev. & Tax. Code section 17024.5 (for tax years beginning on or after Jan. 1, 2015, California generally conforms to the IRC in effect on Jan. 1, 2015); Haw. Rev. Stat. section 235-2.3 (Hawaii conforms to the federal IRC of 1986, as amended as of Dec. 31, 2015); Fla. Stat. section 220.03(1)(n) (Florida conforms to the IRC as it existed on Jan. 1, 2016); and N.C. Gen. Stat. section 105-228.90(b)(1b) (North Carolina conforms to the IRC as it was in effect on Jan. 1, 2016).

[8] *See, e.g.*, Ala. Code section 40-18.1.1 (Alabama conforms to the current version of the IRC); Colo. Rev. Stat. section 39-22-103 (Colorado conforms to the current version of the IRC); 35 ILCS 5/1501(a)(11) (Illinois conforms to the most recent version of the IRC); Or. Rev. Stat. section 317.013(7) (Oregon conforms to the IRC as in effect on Dec. 31, 2015, for tax years beginning on or after January 1, 2016); and Utah Code Ann. section 59-7-101(19) (Utah conforms to the most recent version of the IRC).

[9] National Conference of State Legislatures, "NCSL Fiscal Brief: State Balanced Budget Provisions" (Oct. 2010); *see also* Mason, *supra* note 1, at 1308.

[10] Trump Tax Reform, *supra* note 2, at 1; and House GOP blueprint, *supra* note 3 at 16.

assertions have been questioned,[11] and there is also a possibility that a final federal tax reform package could differ significantly from these two proposals, requiring a new evaluation of the enacted reform package. The Congressional Budget Office and the Joint Committee on Taxation will estimate the budgetary effects of any final tax reform package.[12] States should closely monitor the scoring to estimate how any potential tax reform would affect their budgets.[13] In addition, some states are already facing budget deficits and shortfalls.[14] States may therefore be inclined to conform to federal tax reform provisions that increase the tax base, and less inclined to adopt provisions that shrink receipts. On the other hand, state legislators also face constant political pressure to avoid raising taxes. State legislatures will have to balance these considerations when evaluating conformity.

In this article we will take a closer look at some of the major elements of both the Trump administration plan and House GOP blueprint, and evaluate some of the potential state tax consequences of the proposals.

[11]*See, e.g.*, Jim Nunns et al. "An Analysis of Donald Trump's Revised Tax Plan," Tax Policy Center, Urban Institute and Brookings Institution (Oct. 18, 2016) at 5-6 ("we estimate that the Trump Plan would reduce federal receipts by $6.2 trillion between 2016 and 2026"); Alan Cole, "Fiscal Fact No. 482: Details and Analysis of Donald Trump's Tax Plan," Tax Foundation (Sept. 2015) ("the plan would end up *reducing* tax revenues by $10.14 trillion over the next decade when accounting for economic growth from increases in the supply of labor and capital") (emphasis added); Nunns et al., "An Analysis of the House GOP Plan," Tax Policy Center, Urban Institute and Brookings Institution (Sept. 16, 2016) ("we estimate that a plan such as this would reduce federal revenue by $3.1 trillion over the first decade of implementation and by an additional $2.2 trillion"); and Kyle Palmerleau, "Fiscal Fact No. 516: Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation (July 2016) ("the plan would reduce federal revenue by $2.4 trillion over the first decade on a static basis").

[12]"What Are Dynamic Scoring and Dynamic Analysis?" Tax Policy Center.

[13]Scoring refers to estimating the budgetary effects of tax, spending, and regulatory legislation. The resulting score plays a major role in policy deliberations because of congressional budget rules and public concerns about the budget. Static scoring does not take into account the secondary impact of employment, GDP, and other macroeconomic measures. Dynamic scoring, on the other hand, accounts for these secondary affects. *See id.*

[14]Liz Malm, "Which States Have State Budget Deficits or Shortfalls? That Question Is Harder to Answer Than You'd Think," Multistate Insider, Feb. 23, 2016 ("We count 16 states with FY 2016 and/or FY 2017 budget shortfalls").

III. Potential Federal Corporate Income Tax Reform Elements and Corresponding State Consequences

A. Federal Income Tax Rate Decrease

The federal corporate income tax rate for most large corporations is currently 35 percent.[15] Trump proposes to drop that rate to 15 percent, while the House GOP blueprint proposes to drop it to 20 percent.[16] On its face, a decline in federal tax rates does not appear to have any state tax consequences since states have always imposed their own corporate tax rates, and tax rates do not directly affect the calculation of taxable income. However, a lower federal tax rate may affect states in other ways.

Despite claims that the proposals are revenue-neutral, a lower tax rate (especially such a significant reduction), absent changes to broaden the tax base, could mean lower federal revenue. Lower federal revenue, if larger deficits result, could increase pressure to cut spending. Republican party leadership has already expressed a desire to reduce federal spending in areas such as environmental protection and healthcare, and lower federal revenues could force reductions to other areas of federal spending.[17] In many cases, such reductions could shift the burden of performing those functions to the states, which in turn could lead to the need for states to expand their tax bases.[18]

From a taxpayer perspective, if the federal corporate rate drops while state corporate tax rates remain at current levels, state corporate income taxes immediately become a more significant part of a taxpayer's overall tax burden. Taxpayers may respond by shifting more

[15]IRC section 11.

[16]Trump Tax Reform, *supra* note 2 at 1; and House GOP blueprint, *supra* note 3, at 25. Trump reiterated his call for a top corporate tax rate of 15 percent in his April 26 announcement. *See supra* note 4.

[17]*See, e.g.*, Office of Management and Budget, "America First: A Budget Blueprint to Make America Great Again" (Mar. 13, 2017) (proposing a 21 percent cut to the Department of Agriculture, a 16 percent cut to the Department of Commerce, a 13 percent cut to the Department of Education, a 5.3 percent cut to the Department of Energy, a 17.9 percent cut to the Department of Health and Human Services, a 13 percent cut to the Department of Housing and Urban Development, and a 13 percent cut to Department of Transportation).

[18]Peter L. Faber, "The Impact of Federal Tax Reform on State and Local Taxation," *State Tax Notes*, Mar. 6, 2017, p. 647-648.

attention and resources to the calculation and analysis of their state income tax burden.

Many taxpayers may try to take advantage of the federal rate reduction by evaluating federal accounting method changes to accelerate deductions and defer income. This may have unintended consequences on their state tax profiles. Some state deferred tax attributes have expiration dates that differ from federal tax attributes. Taxpayers will want to weigh the net effect of accelerating deductions and deferring income against the possible cost of losing some state deferred tax attributes. For example, net operating loss carryforwards or specific state credit carryforwards may have short expiration periods that will end soon.[19] Accelerating deductions and deferring income will reduce the potential use of these deferred tax attributes. Taxpayers should therefore evaluate the potential consequences of any accounting method changes incorporating a full analysis of the state tax impact as well.

B. Full Expensing of Business Investment

The House GOP blueprint provides businesses with the benefit of fully and immediately writing off (expensing) the cost of investments — in particular, investments in tangible property, such as equipment and buildings, and intangible assets, such as intellectual property.[20] This full expensing proposal would not apply to land.[21] As a consequence of this shift, companies would lose the ability to deduct their net interest expense.

Trump's stance on the issue of business expensing, on the other hand, has evolved over the course of his presidential campaign. His original tax reform plan from 2015 did not propose to allow full expensing of capital investments in year one.[22] In a subsequent speech, however, Trump announced that he did, in fact, support full expensing.[23] In a later fact sheet that accompanied another campaign speech, he stated that only firms engaged in U.S. manufacturing could elect to deduct the full cost of their capital investments in year one, and any taxpayer that made this election would lose the ability to deduct interest expense.[24] While Trump did not specifically include the proposal for full expensing in the one-page outline released on April 26, the updated plan did not explicitly reject the proposal, either.[25] This provision was not among the policies enumerated in the president's recent tax reform outline, but because he proposed a variation of it during the campaign, and because it is also included in the House GOP blueprint, we will explore the possible state and local ramifications in more detail.

From a revenue perspective, the House GOP proposal to allow for immediate expensing, at least viewed in isolation, shrinks the tax base in the first year — although this revenue loss from immediate expensing is arguably offset in future years through the loss of subsequent depreciation deductions. The corresponding revenue loss could be problematic for states trying to balance their budgets. The ways in which states reacted to the federal bonus depreciation provisions may provide a roadmap to how the states may react to the immediate expensing proposal. The federal depreciation rules generally require the cost of assets to be recovered through deductions over the useful life of the underlying assets. But starting in 2002, federal legislation allowed an additional first-year depreciation deduction for property placed in service during specific time periods.[26] For example, the Jobs and Growth Tax Relief Reconciliation Act of 2003 provided an additional first-year depreciation deduction equal to 50 percent of the adjusted basis for property placed in service by the taxpayer between 2003 and 2005. Subsequent legislation extended or expanded these bonus depreciation deductions.[27]

[19] *See, e.g.*, IRC section 172 (the federal code allows a 20-year carryforward period); and Ark. Code Ann. section 26-51-27(1)(B) (Arkansas allows a five-year carryforward period).

[20] House GOP blueprint, *supra* note 3, at 25–26.

[21] *Id.*

[22] Trump Tax Reform, *supra* note 2.

[23] Trump Remarks, *supra* note 2.

[24] Trump Fact Sheet, *supra* note 2.

[25] *See supra* note 4.

[26] *See* H.R. 3090, 107th Cong. (2002) (enacted).

[27] *See generally* IRC section 168(k); *See, e.g.*, H.R. 2029, 114th Cong. (2015) (enacted).

These provisions sought to provide an economic stimulus through an incentive for companies to purchase capital assets.[28]

So how did states respond to the bonus depreciation provisions? As one would expect, the responses varied. Some states declined to conform, either through enacting decoupling legislation or by not updating conformity statutes, while other states conformed, either through automatic rolling conformity or by updating conformity statutes.[29] Further, some states generally do not decouple for most aspects of the calculation of taxable income, but may decouple from the federal bonus depreciation regime for specific tax years[30] or for specific kinds of taxpayers.[31] Many states decouple from bonus depreciation, at least in some respect.[32] Thus, if history is any indication, state legislatures may be disinclined to conform to the full expensing of capital assets.

Decoupling from the House GOP full expensing proposal would result in state tax issues separate from merely adding back the full expensing deductions to state taxable income. For example, depreciation results in a reduction in tax basis in the asset. Where there is a difference between federal and state depreciation, by definition there is also a federal-state difference in the tax basis of the asset. Therefore, when the assets are sold, there may also be a difference in the gain recognized for federal and state purposes. Under the House GOP proposal, the basis in the asset would presumably be zero, and gain will be recognized on the entire amount of the proceeds. If states decouple from full expensing and retain depreciation, there could be a federal-state difference in basis, and thus potentially a lesser amount of gain recognition in the decoupling states when the assets are sold. Taxpayers should be well versed in these differences, as decoupling from full expensing may magnify these differences.

The Trump proposal, which was released during the campaign, of an election for full expensing may have the same stimulus effect as the House GOP blueprint but is narrower in scope since it would only apply to "United States Manufacturers" — a critical and nuanced term that is not defined — and would require electing taxpayers to forgo their interest expense deduction. The impacts of the Trump proposal are discussed in the next section, which deals with the elimination of interest expense.

C. Elimination of Interest Expense

The House GOP proposal would eliminate the net interest expense deduction. Taxpayers would be allowed to deduct only interest expense against any interest income, but no current deductions would be allowed for net interest expense.[33] Under the plan, any net interest expense could be carried forward indefinitely and allowed as a deduction against net interest income in future years.[34]

Trump's proposal has evolved. The campaign initially proposed a reasonable cap on the deductibility of business interest.[35] However, Trump's subsequent statement during the campaign proposed to allow manufacturing firms to elect to either deduct the full cost of their capital investments in year one or deduct their interest expense.[36] While the interest expense deduction was not specifically mentioned in Trump's April 26 announcement, the president's tax plan calls for eliminating "tax breaks for special interests."[37] Applying the same reasoning as we did to the omission of immediate expensing in the president's recent tax reform outline, we will explore the state and local ramifications of limiting the interest expense deduction as well.

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[28] H.R. Rep. No. 107-251, at 17 (2002) ("The bill will provide tax relief for businesses and individuals that will stimulate many sectors of the economy").

[29] *See generally* Virginia Department of Taxation, "Reaction of Other States to the Job Creation and Worker Assistance Act of 2002" (Aug. 26, 2002).

[30] *See, e.g.*, Ala. Code section 40-18-33 (Alabama generally conforms to bonus depreciation except decoupled in 2008).

[31] *See, e.g.*, Alaska Stat. section 43.20.072(b)(4); and Alaska Admin. Code tit. 15, section 20.480(b) (however, Alaska generally requires oil and gas taxpayers to use IRC section 167 to compute depreciation as it was on June 30, 1981, before bonus depreciation was enacted).

[32] *See generally* "State Conformity with Federal Bonus Depreciation Rules," Bloomberg BNA, Mar. 31, 2016.

[33] House GOP blueprint, *supra* note 3, at 26.

[34] *Id.*

[35] Trump Tax Reform, *supra* note 2, at 2.

[36] Trump Fact Sheet, *supra* note 2.

[37] *See supra* note 4.

The House GOP proposal to eliminate the deduction for net interest expense would expand the tax base. It is reasonable to assume that states, particularly those with budgetary concerns, would be inclined to adopt these provisions — indeed, many states already have enacted provisions denying interest expense deductions. However, states and taxpayers may need to look beyond the revenue impact and evaluate how these provisions interact with existing state and federal provisions related to interest.

For example, many states that require corporate taxpayers to file separate returns (rather than unitary combined or consolidated returns) have provisions that require interest expense paid to a related party to be added back to taxable income, in some cases subject to safe harbor exceptions.[38] Any tax reform proposal relating to interest expense could have a corresponding effect on these provisions, such as the potential elimination of safe harbors that allow for state deductions of interest. If states conform to the House GOP proposal, for example, the need for related-party addback statutes would arguably decline because there would no longer be a net interest expense deduction embedded in the starting point for computing state taxable income. On the other hand, states may decide to conform to the House GOP proposal and leave in place the related-party interest statutes. Under this scenario, the related-party interest might still be disallowed and may not be netted against interest income or carried forward, limiting the interest income deduction even further than the House GOP proposal.

Trump's campaign proposal on interest expense appears to apply only to U.S. manufacturers. Any potential impact will therefore be narrower because it applies to a limited cross section of taxpayers that opt for it. However, this narrow application has unique state tax implications. For example, the Trump approach would need to define what constitutes a U.S. manufacturer. Many states have their own definitions of a manufacturer for specific state tax benefits.[39] If states conform to the Trump administration plan's election for full expensing, they will also have to determine whether to conform to the federal definition of U.S. manufacturer or use their own definition.

Assuming that the Trump campaign proposal is adopted and states conform to the interest expense proposal, some taxpayers would have a choice between full expensing of capital assets or interest expense deductions. One consideration for the state legislatures is whether to allow taxpayers to make a separate election for state-only purposes. For example, in the context of an IRC 338(h)(10) election, which allows taxpayers to treat a sale of stock as a deemed sale of assets, most states do not have a separate state-only election,[40] but California allows taxpayers to make an independent election.[41]

Assuming that the federal election is binding at the state level, taxpayers should consider the state tax impact of making the election. For example, consider a hypothetical taxpayer whose interest expense slightly exceeds its purchases of capital assets. However, the interest is paid to related parties. From a federal perspective, electing to deduct the interest expense would be slightly more beneficial than electing full expensing of capital assets. But from a state tax perspective, most, if not all, of the interest expense would be disallowed under a related-party addback statute, whereas the state deductions for the capital asset purchase may be available. This differing state tax treatment could dictate which election is more beneficial overall. Hence, taxpayers should also take into account the state tax consequences in analyzing the benefits of making federal elections.

The House GOP and Trump proposals related to interest expense would also affect other federal provisions, such as the recently enacted Treasury

[38] *See, e.g.*, Ark. Code Ann. section 26-51-423(g).

[39] *See, e.g.*, California Code of Regs. tit. 18, section 1525.4 (defines manufacturer for purposes of California's partial sales and use tax exemption); and N.Y. Tax Law section 210.1(a)(vi) (defines manufacturer for purposes of New York's 0 percent tax rate).

[40] Heather M. Field, "Binding Choices: Tax Elections & Federal/State Conformity," 32 *Va. Tax Rev.* 527, 585 (2013) (most states, however, prohibit independent section 338(h)(10) elections).

[41] California Franchise Tax Board, Chief Counsel Ruling 2008-2 (Sept. 15, 2008); and Cal. Rev. & Tax. Code sections 24451, 23051.5(e) (allowing taxpayers to make different elections, including for section 338(h)(10) elections). The California legislature has considered requiring taxpayers to make the same election for California purposes as is made for federal tax purposes. Field, *supra* note 40, at 590 n.11.

regulations promulgated under IRC section 385.[42] The section 385 regulations provide several rules around whether specific items of debt should be recharacterized as equity. The goals of the regulations include preventing the use of interest expense deductions when the underlying debt is determined to be equity.[43] By eliminating the ability to deduct net interest expense, the House GOP proposal may effectively render the section 385 regulations moot.

However, assuming that states do not conform to the elimination or limitation of the interest expense deduction, states may still decide to look to the section 385 regulations to recharacterize debt as equity. Some states, such as Massachusetts, already use common law principles to recharacterize debt as equity.[44]

D. Elimination of Deductions and Credits

Both the Trump and the House GOP proposals (including Trump's April 26 update) state they will eliminate so-called special interest deductions and credits. The Trump proposal avoids specifics, but broadly states that corporate loopholes that cater to special interests, as well as deductions made unnecessary or redundant by the new lower tax rate on corporations and business income, will be eliminated.[45]

The House GOP proposal also claims that it will eliminate special interest deductions and credits in favor of providing lower tax rates for all businesses and eliminating taxes on business investment while also avoiding extensive detail. The only example it provides is that the domestic production deduction in IRC section 199 would no longer be necessary.[46]

Any provisions that eliminate deductions and credits would expand the tax base. States may be inclined to conform to these provisions to broaden their bases.

The House GOP proposal also addresses limitations on net operating loss carryovers. The House GOP proposal provides that NOLs will be allowed to be carried forward indefinitely, and will be increased by an interest factor that compensates for inflation and a real return on capital to maintain the value of amounts that are carried forward. NOL carrybacks will not be permitted, and the deduction that is allowed regarding an NOL carryforward in any year will be limited to 90 percent of the net taxable amount for the year determined without regard of the carryforward.[47]

States have long had their own limitations on NOL carryovers.[48] Some states suspend the use of NOL carryovers during tight economic times.[49] Federal limits on the use of NOL carryovers would create more complexity, and in states that adopt the federal NOL rules, there may be additional state limits to track.

E. Taxation of Future Foreign Profits

The United States has a hybrid worldwide/water's-edge tax system, which means domestic companies must pay federal income tax on all their income regardless of where it's earned. However, multinational companies doing business in the United States can defer or delay paying U.S. corporate income taxes on active overseas profits by keeping those profits offshore.[50] Domestic corporations use this tax deferral by forming subsidiaries in the countries where they do business. Foreign subsidiaries are not considered U.S. corporations even if wholly owned by a domestic parent, so the overseas profits of these subsidiaries are not immediately

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[42] *See* Treas. reg. sections 1.385-1; 1.385-2; 1.385-3; 1.385-3T; and 1.385-4T.

[43] *See* Treas. reg. sections 1.385-1.

[44] *See, e.g.*, *National Grid USA v. Commissioner of Revenue*, 89 Mass. App. Ct. 506 (2016) *appeal denied* 475 Mass. 1104 (2016); *Overnite Transportation Co. v. Commissioner of Revenue*, 54 Mass. App. Ct. 180 (2002); *N.Y. Times Sales Inc. v. Commissioner*, 40 Mass. App. Ct. 749, 753 (1996); *Staples Inc. v. Commissioner of Revenue*, No. C310640 (Mass. App. Tax Bd. 2015); and *The TJX Cos. Inc. v. Commissioner of Revenue*, No. C26229-31 (Mass. App. Tax Bd. 2007).

[45] Trump Tax Reform, *supra* note 2, at 2; *see also supra* note 4.

[46] House GOP blueprint, *supra* note 3, at 26-27.

[47] *Id.* at 27.

[48] *See, e.g.*, Conn. Gen. Stat. section 12-217(a)(4) (subtraction from net income attributable to state sources allowed for NOL carryforward, except the amount of carryforward for income years commencing on or after January 1, 2015, is limited to the lesser of 50 percent of net income or apportionable net income, and the excess of NOL over the NOL being carried forward from prior income years.)

[49] *See, e.g.*, 35 Ill. Comp. Stat. 5/207(a)(3) (suspending NOL carryforward deduction for tax years ending after December 31, 2010, and before December 31, 2012).

[50] Seth Hanlon, "Offshore Tax Deferral: Counting Down the Country's Biggest Tax Breaks, Week by Week," Center for American Progress (Mar. 6, 2011).

subject to U.S. corporate income tax. The domestic parent need not pay taxes on a subsidiary's offshore profits unless and until the profits are returned to the United States — for example, when the subsidiary pays dividends to the parent.[51]

Trump's campaign proposal was to build on the current worldwide tax system — while still retaining the foreign tax credit so taxpayers are not double taxed — by ending the tax deferral of overseas profits.[52] It's unclear from the initial proposal exactly how the Trump plan would remove the tax deferral mechanism — perhaps by making U.S.-owned foreign corporations subject to corporate income tax. The House GOP blueprint, on the other hand, proposes moving away from a residence-based tax system, which taxes the worldwide income of residents, to a territorial tax system. Under a territorial approach the taxing jurisdiction taxes income earned within its borders. Under this system, the United States would tax income generated by sales to the U.S. market while excluding from federal income taxation any active income earned outside the United States, regardless of the taxpayer's residency.[53]

The president's April 26 update appears to adopt the House GOP blueprint's proposal of a territorial regime.[54] While this can reasonably be interpreted as a sign that the Trump administration is no longer pushing for his initial worldwide tax/foreign tax credit proposal, this article will analyze the state tax consequences raised by the original proposal.

For state corporate income tax purposes, the impact of a worldwide versus territorial system must be evaluated by examining how foreign affiliates are treated under the various state filing methods for reporting income among affiliates. This article will focus on the impact under two of the methods: separate return and unitary combined returns. Under any of the filing methods, foreign affiliates will generally continue to have a filing requirement if they are subject to tax in a particular state, regardless of whether they are subject to federal tax.[55]

A separate return filing requires each corporation subject to state tax to file its own separate return, regardless of whether it is part of an affiliated or consolidated group.[56] A foreign affiliate would therefore only file in a separate state if it were subject to tax in that particular state.

Under the unitary method, which is a requirement for all combined filings and for some consolidated filings, all of the elements composing a single trade or business are viewed as a whole, hence the term "unitary."[57] The business income from all activities of a unitary business is combined into a single report, whether such activities are conducted by division of a single corporation or by members of a commonly controlled group of corporations.[58]

Under the unitary method, inclusion of foreign affiliates depends on whether the state is a water's-edge or worldwide filing state. A water's-edge filing limits the scope of the unitary group to specific corporations or portions of corporations whose income is subject to tax directly or indirectly by the federal government.[59] For example, an entity incorporated in the United States would be includable in the water's-edge combined report because an entity incorporated in the United States is subject to U.S. taxation on all its income. But an entity incorporated in a foreign country that lacks sufficient connections to the United States would not be included in the water's-edge combined report

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[51]The IRC has anti-deferral provisions for passive income from U.S.-owned foreign corporations, but not for active business income. *See* IRC sections 951–954 (subpart F).

[52]Trump Tax Reform, *supra* note 2, at 4.

[53]House GOP blueprint, *supra* note 3, at 25-26.

[54]*See supra* note 4.

[55]*See generally* Mike Porter, et al., "Foreign Companies and State Income Tax Nexus," *State Tax Notes*, Sept. 19, 2016, p. 943.

[56]*See, e.g.*, N.J. Admin. Code tit. 18, section 7-11.15 (New Jersey is a separate reporting state).

[57]*See* California Franchise Tax Board, Publication 1061 (2015).

[58]*See Id.*

[59]*See generally* California Franchise Tax Board, "Water's Edge Manual" (Jan. 2004).

because the corporation is not subject to federal income taxation.[60] However, within those extremes there are several complex rules for inclusion and exclusion.[61] A worldwide report, on the other hand, includes the income of all unitary members of the combined report, regardless of where these entities are incorporated.[62]

The history of water's-edge filing provides a fascinating look into how states may respond to the Trump administration plan's potential worldwide filing report.[63] Currently, there are no states that require a worldwide filing without also providing a water's-edge election.[64] Stated slightly differently, no state mandates a worldwide filing. It was not always this way, however. States that originally adopted the unitary combined filing method decades ago typically required a worldwide method of reporting; but over time, states have moved away from worldwide filing to water's-edge filings. States generally moved in this direction based on a combination of political and economic pressures (that is, the loss and threat of loss of foreign economic investment).[65] California, for example, faced litigation over its use of the unitary worldwide method. While California's worldwide method of reporting was ultimately upheld,[66] the state amended its statutes to allow for a water's-edge election in the face of international pressure.[67]

If the federal government moves to a pure worldwide method of reporting with no deferral for profits earned overseas by foreign affiliates of U.S. taxpayers, this may provide an opening for states to finally adopt the worldwide filing method without significant opposition. On the other hand, the political and economic pressure that existed decades ago may be just as strong or even stronger for states to retain water's-edge or separate filings. A recent California bill, S.B. 567, included a provision to eliminate the water's-edge election.[68] However, after significant opposition,[69] the provision was removed.[70]

It should also be noted that there are circumstances in which taxpayers benefit from moving to a worldwide filing method. Moving to a worldwide filing method may be a revenue raiser for a particular state because the worldwide method generally expands the tax base. But that is not always the case. Moving to a worldwide filing method can also shrink the tax base because foreign losses are being brought into the group. The apportionment factors of foreign affiliates would also be brought into the factor, potentially diluting the domestic apportionment factor.

From an administrative perspective, moving to a worldwide filing or a complete territorial regime would eliminate some of the need for complex state inclusion rules. For example, a water's-edge filing generally includes U.S. corporations, but also includes foreign corporations subject to tax in the state. But these entities (or even U.S. entities) can be excluded under a state's 80/20 rules, which exclude companies with 80 percent or more of their activity outside the United States.[71] These rules are designed to prevent an entity with foreign activities from diluting the apportionment factor with overseas activity.

[60] *Id.*

[61] *Id.*

[62] *See, e.g.*, D.C. Mun. Regs. tit. 9, section 162.1. ("the member or members of the combined group engaged in a unitary business may elect to determine their apportioned share of the aggregate taxable net income or loss derived from the unitary business pursuant to a worldwide election under which each member shall take into account the income and apportionment factors of all the members, wherever located, includable in the combined group").

[63] *See generally* Nancy Foran and Dahli Gray, "The Evolution of the Unitary Tax Apportionment Method," 15 *Acct. Historians J.* 65 (Spring 1988); and Marlis L. Carson, "Barclays, Colgate and WWCR Get Their Day in Court," *State Tax Notes*, Apr. 4, 1994.

[64] California is unique in that its default method is worldwide filing, but it allows taxpayers to elect a water's-edge method.

[65] *See* Foran and Gray, *supra* note 63, at 79; and Carson, *supra* note 63, at 8.

[66] *See Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

[67] Carson, *supra* note 63, at 8. Before the amendment providing for the water's-edge option, the British government had threatened retaliatory measures against both the United States and California in response to California's adoption of the worldwide method. *Id.*

[68] S.B. 567, 2017-2018 Leg. Sess. (Cal. 2017).

[69] Letter from Peter Blocker, Legislative Advocate to Members, Senate Governance and Finance Committee on Opposition to S.B. 567, Mar. 21, 2017.

[70] Email from Peter Blocker, Legislative Advocate to California Taxpayer Association Members on "Water's Edge Elimination Defeated," May 4, 2017.

[71] *See, e.g.*, 39 Colo. Code Regs. section 22-303(12)(c).

In addition, a worldwide filing method would eliminate the need for recently enacted tax haven legislation. Some states have enacted statutes or are considering legislation requiring entities incorporated in specific tax haven jurisdictions to be included in the unitary return even though they are not domestic entities or have nexus with the state.[72] Perhaps moving to a mandatory worldwide filing regime would eliminate some of the complexity with electing a water's-edge return as well. California, for example, has complex rules regarding how and when to make a water's-edge election.[73]

Ultimately, if federal tax reform includes a shift to a pure worldwide or a territorial tax regime, there is no guarantee that the states will uniformly conform to such a change. Although nonconformity may be reasonable or even necessary for a particular state due to budgetary concerns, states and taxpayers should consider the resulting complexity that may follow from nonconformity.

F. Border-Adjustable Tax

A significant piece of the House GOP proposal (and perhaps the most controversial[74]) is the border-adjustable tax. The blueprint proposes to effectively change the current income tax to what has been described as a "destination-based cash flow tax." The blueprint would achieve the destination-based component of this description by exempting export revenues from taxation while excluding imports from a cost of goods sold deduction.[75]

In determining whether to conform to or decouple from a border-adjustable tax, a state will first need to determine the potential revenue impact. At the federal level, the border-adjustable tax will likely increase revenue because the United States is a net importer — U.S. imports exceed exports.[76] However, states will need to separately evaluate whether they themselves are net importer or net exporter states. If the state is a net importer, the border-adjustable tax may expand the tax base since imported goods would no longer be included in the cost-of-goods-sold calculation. If the state is a net exporter, then the border-adjustable tax would shrink the state's tax base because exported goods would not be subject to taxation. Net exporter states simply may not be able to afford to conform to the tax.

Second, states will need to look to their constituencies. The border-adjustable tax affects different industries in different ways. For example, the retail industry has raised significant objections to the border-adjustable tax because retail generally relies heavily on imported goods.[77] Other industries — for example, high-end manufacturing, technology, aerospace, and defense — have praised the border-adjustable tax because these companies generally conduct manufacturing and development in the United States.[78] States will thus need to determine which industries are predominant in their jurisdictions and how they will be affected by conforming to the border-adjustable tax.

Third, states should consider the potential impact on apportionment. If a state conforms to the border-adjustable tax, it may require that export sales be excluded from the sales factor to be consistent with federal provisions. If states do not conform, however, they may need to revisit their definition of sales to verify whether export sales are still included in the apportionment factor. Conformity could be even more complex in states that impose throwback rules that source sales to the states from which sales are shipped if the seller is not taxable in the destination state. It is unclear how this would work in the context of export sales under a border-adjustable tax.

Fourth, states should consider the administrative challenges associated with

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[72] *See generally* Scott Schiefelbein, "State Tax Haven Laws — Expanding the Water's-Edge Group," *State Tax Notes*, Nov. 2, 2015, p. 367.

[73] *See, e.g.*, California Franchise Tax Board, Notice 2016-02 (Sept. 9, 2016).

[74] John Harwood, "There's a Battle Going on Inside the GOP Over the Border-Adjustment Tax, and It's Not Going Away," CNBC, Mar. 2, 2017; Americans for Affordable Products release, "Well Over 100 Businesses & Trade Associations Launch Americans for Affordable Products to Stop Border Adjustment Tax," Feb. 1, 2017; and National Retail Federation release, "NRF Launches Campaign Highlighting Consumer Cost of Border Adjustment Tax," Feb. 28, 2017 (hereinafter NRF Press Release). Trump's April 26 outline did not include a reference to the border-adjustable tax. *See supra* note 4.

[75] House GOP blueprint, *supra* note 3, at 27.

[76] House GOP plan analysis, *supra* note 11, at 6.

[77] AAP release, *supra* note 74; NRF release, *supra* note 74.

[78] American Made Coalition, Informational Resource Packet (Mar. 1, 2017).

decoupling from a cash flow tax. The starting point for nearly every state's taxable income is federal taxable income. If a state were to decouple, it would have to find another way to calculate state corporate income, and this may be difficult. In addition, if federal tax reform were to include the border-adjustable tax, on a prospective basis federal income tax audits would focus on a calculation of federal taxable income tax very different from the current calculation. For many states, a federal income tax audit examines the foundation for the computation of state taxable income. If a state were to decouple from a federal border-adjustable tax, a federal audit of a particular taxpayer may not examine a number of critical issues relevant to the calculation of the taxpayer's pro forma federal taxable income based on the system in effect today. This will likely place a greater burden on taxpayers and state tax auditors to evaluate every aspect of a state tax return.

Finally, states should keep in mind specific federal constitutional limitations. The commerce clause provides that "Congress shall have the Power to Regulate Commerce with foreign nations and among the several states, and with the Indian tribes." This provision has been interpreted as prohibiting state taxes from placing an impermissible burden on either foreign or interstate commerce.[79] In *Japan Line Ltd. v. County of Los Angeles*, the U.S. Supreme Court wrote that to withstand scrutiny under the commerce clause, a state tax must "not discriminate against interstate or foreign commerce."[80] The border-adjustable tax potentially discriminates against foreign commerce by placing additional burdens on imports that it does not place on exports. States will need to closely consider the commerce clause implications of the border-adjustable tax, because as the Court stated in *Kraft v. Iowa*, "the adoption of the federal system, in whole or in part, however, cannot shield a state tax statute from Commerce Clause scrutiny."[81] That the border-adjustable system potentially discriminates against foreign commerce is likely to be a source of litigation if the border-adjustable tax is enacted.[82]

G. Deemed Repatriation

As discussed above, the federal income tax system allows for deferral of tax on overseas profits. Accordingly, many companies maintain a significant amount of untaxed foreign profits overseas. The JCT estimated that multinational corporations had approximately $1.8 trillion of untaxed overseas profits in 2012 and $2.4 trillion of untaxed overseas profits in 2015.[83] Most American politicians — at both the federal and state level — would like to see that money returned to the United States with the hope that it would be reinvested domestically rather than abroad. The sticking point has been how best to achieve this goal. As a presidential candidate, Trump proposed a one-time "deemed repatriation" of untaxed foreign profits at a significantly discounted 10 percent tax rate. This tax would be imposed even if companies leave the cash overseas, meaning this would not be a tax holiday that imposes a reduced tax on amounts actually repatriated.[84] Trump reiterated this position in his updated April 26 tax reform outline, although the outline did not specify the applicable tax rate.[85]

The House GOP blueprint also has a deemed repatriation provision.[86] Accumulated foreign earnings would be subject to tax at 8.75 percent to the extent held in cash or cash equivalents, and otherwise would be subject to tax at 3.5 percent (with companies able to pay the resulting tax liability over an eight-year period).[87] The blueprint would also provide for a 100 percent exemption for dividends from foreign subsidiaries for future active earnings.[88]

[79] *Kraft General Foods v. Iowa Department of Revenue & Finance*, 505 U.S. 71, 82 (1992).

[80] *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1981).

[81] *Kraft*, 505 U.S. at 82.

[82] Some believe the border-adjustable tax also potentially violates international trade agreements, and that its enactment will result in litigation at the WTO. Brian Faler, "Why Some Worry GOP Tax-Reform Plan Will Spark a Trade War," *Politico*, Dec. 6, 2016.

[83] Letter from JCT Chief of Staff Thomas A. Barthold to Reps. Kevin Brady, R-Tex., and Richard E. Neal, D-Mass., Aug. 31, 2016.

[84] Trump Tax Reform, *supra* note 2, at 2.

[85] *See supra* note 4.

[86] House GOP blueprint, *supra* note 3, at 28.

[87] *Id.*

[88] *Id.*

Given the broad strokes in which both the Trump plan and House GOP blueprint are written, many details remain to be seen regarding the federal tax treatment of the deemed repatriation. For example, it is reasonable to assume that the deemed repatriation would be considered a dividend for federal income tax purposes. However, dividend treatment is not guaranteed. During the ebb and flow of tax reform negotiations, could the deemed repatriation be treated as a separate class of miscellaneous income, or as gross receipts reported on Line 1 of the federal corporate income tax return? How the deemed repatriation is defined as an item of income for federal purposes will have a direct impact on how it would be treated by the states. For example, if the deemed repatriation is considered income reported on Line 29 of the federal corporate income tax return, the state tax treatment of the income will vary widely depending on whether states use federal taxable income as reported on Line 28 or Line 30 as the starting point for calculating state taxable income.[89]

We expect states generally to support the deemed repatriation as a one-time infusion of tax revenues. However, any potential windfall at the state level created by the deemed repatriation will be affected by how states address the numerous tax considerations triggered by it. Perhaps states will create their own separate tax rates on the deemed repatriation. Another possibility is that the income would simply be included in the new state tax base in the year of the deemed repatriation. If the income is included in the tax base, what is the character of the income? Will it be a deemed dividend, miscellaneous income, or apportionable gross receipts? Assuming that the income is characterized as a deemed dividend, many states have dividends received deductions, and thus taxpayers may want to explore the state rules for those deductions to determine whether they can partially or fully deduct the deemed dividend.[90]

Another consideration is which entity in the consolidated federal group will be deemed to receive the deemed repatriation. Many state filing groups differ from the federal affiliated group, and thus the deemed repatriation could potentially be excluded from the state tax base if the entity receiving the income is not in the tax filing group in a specific state. Similarly, the deemed recipient entity may be an entity with a limited filing footprint (for example, a holding company with no business activity). This disconnect between federal and state filing groups may also create opportunities for tax planning as well as potential exposure. Taxpayers may want to isolate the activities of the entity receiving the deemed income to limit the number of states where the recipient has a filing obligation, or take steps to dilute its apportionment factors.

Questions will also arise regarding how the income (if included in the tax base) will be apportioned or allocated. Taxpayers will need to determine whether the income should be characterized as business income and apportioned, or characterized as nonbusiness income and allocated. If the income is business income, taxpayers will also need to determine if the income should be included in the sales factor, as some states have occasional sales rules that exclude receipts that are occasional or incidental in nature.[91] If includable in sales, taxpayers will then need to determine if the sale should be included in the numerator of the sales factor. This is another challenging area, as the rules for sourcing sales other than tangible personal property are complex and vary by state. If the income is nonbusiness, taxpayers will need to determine how the income should be allocated. State legislatures and taxing agencies may provide guidance on how to apportion or allocate these items, or taxpayers will otherwise have to rely on existing statutory and regulatory guidance to determine how to treat them.

H. Reinvesting in America

Both the House GOP blueprint and the Trump plan are designed to encourage reinvestment in America. Both propose lower tax rates to make the United States more competitive with the tax rates of foreign countries. Both plans' deemed repatriation

[89] *See, e.g.*, Alabama Department of Revenue, Corporation Income Tax Return Instructions (line 30 of the return); and Instructions and Worksheet to Alaska Form 0405-6000, Corporation Net Income Tax Return (line 28 of the return).

[90] *See, e.g.*, Ariz. Rev. Stat. Ann. section 43-1122(11).

[91] *See, e.g.*, Alaska Admin. Code tit. 15, section 19.302(a).

tax proposals are designed to bring cash into the United States from overseas. The border-adjustable tax arguably favors exporters over net importers (assuming there is not a commensurate and immediate appreciation in the value of the U.S. dollar), and therefore likewise may encourage investment in the United States.

Companies looking to reinvest in America will also need to closely analyze credits and incentives that vary in type and magnitude across the state and local landscape. Many state and local governments offer tax credits and financial incentives that are aimed at increasing employment and attracting new investment into their communities.[92] In addition to traditional income tax incentives, such as job creation and investment tax credits,[93] consideration should be given to available sales tax exemptions, property tax abatements, training grants, and infrastructure improvement opportunities.[94] Taxpayers considering negotiated incentives with state and local governments may wish to start this process now, considering the potential for a long time frame to successfully execute such projects.

I. Next Steps

Corporations should start preparing for both the federal and state consequences of federal tax reform. First, corporations should undertake a detailed analysis of their federal and state deferred tax assets and valuation allowances. Federal tax reform will change the federal and state tax profile of corporations, and this will impact federal and state tax deferred assets and valuation allowances. Second, corporations should carefully review any uncertain tax positions and determine whether any greater certainty can be achieved regarding these positions. Finally, corporations should do high-level modeling of both the federal and state impact to recognize where they have significant exposure, and put in place potential plans to address the effects of tax reform.

IV. Conclusion

Taxpayers should closely monitor tax reform developments. While House Speaker Paul Ryan, R-Wis., and Mnuchin have both claimed that tax reform will be passed by August of 2017,[95] recent comments by Mnuchin and Senate Majority leader Mitch McConnell, R-Ky., indicate this deadline is likely to be extended.[96] Several other competing and complex legislative priorities remain that will require a great deal of attention and effort in the coming weeks and months — including addressing appropriations legislation needed to prevent a government shutdown on October 1, raising the statutory debt limit, and the continued legislative activity around repealing and replacing the Affordable Care Act.[97] In addition, the details and nuances of the Trump administration plan are far from clear, and the GOP's plan, although more detailed, also lacks nuance and consensus. The president's April 26 announcement did not elaborate on his tax reform vision. The border-adjustable tax continues to be controversial, and given the degree of opposition, it's unclear that the border-adjustable tax will be included in an eventual tax reform package.[98]

Regardless of what any final tax reform bill looks like, however, a potential exists for significant federal-state differences if a material number of states do not conform to various federal proposals. Considering the common goals and themes in both the Trump administration plan and the House GOP blueprint — growth of the American economy while broadening the tax base and reducing tax rates — and that Republicans control both branches of Congress and the executive branch, taxpayers should not delay in analyzing and planning for the dizzying array of potential state reactions to federal tax reform. ■

[92] Alan Greenblatt, "States Double Down on Incentives to Woo Companies," Governing the State and Localities, *Governing*, Jan. 2013.

[93] *See, e.g.*, Ga. Code Ann. section 48-7-40 (Georgia jobs and investment credit).

[94] *See, e.g.*, Calif. Code of Regs. tit. 18 1525.4 (California partial sales and use tax exemption for manufacturing and R&D).

[95] Scott Wong and Alexander Bolton, "Ryan Maps Out GOP Timeline for ObamaCare, Tax Reform," *The Hill*, Jan. 25, 2017; and Vicki Needham, "Mnuchin Promises Tax Reform by August," *The Hill*, Mar. 1, 2017.

[96] Naomi Jagoda, "Mnuchin: White House Tax Plan Coming 'Very Soon,'" *The Hill*, Apr. 20, 2017; and Jordain Carney, "McConnell: Tax Reform Unlikely By August," *The Hill*, Mar. 9, 2017.

[97] *See, e.g.*, Rachael Bade and Jennifer Haberkorn, "House GOP Leaders Won't Rush Health Care Vote," *Politico*, Apr. 22, 2017; Andrew Velarde, "Healthcare 'Debacle' Raises Tax Reform Stakes, Kies Says," *Tax Notes Today*, Mar. 30, 2017; and Associated Press, "GOP Health Care Failure Will Make Tax Reform Much Harder," CBS News, Mar. 29, 2017.

[98] Harwood, *supra* note 74.