President Trump's Tax Reform Proposal – Multistate Tax Considerations

Overview

On April 26, 2017, the Trump administration released a one-page fact sheet outlining principles for tax reform (the "Proposal"), with the stated goals of: (1) growing the economy; (2) simplifying the tax code; (3) providing tax relief to American families, and (4) lowering the business tax rate.[1] These goals and some additional context to the Proposal were provided by Treasury Secretary Steven Mnuchin and National Economic Council Director Gary Cohn at an April 26th press briefing. During this briefing, Mnuchin and Cohn announced that a formal proposal would be released this summer.

This tax alert highlights the various federal income tax elements of the Proposal and provides an overview of the associated multistate tax considerations.[2]

Individual Tax Reform

As it relates to individuals, the Proposal provides tax relief by reducing the seven current income tax brackets which range from 10% to 39.6% to three brackets of 10%, 25% and 35%, doubling the standard deduction and providing tax relief for families with child and dependent care expenses. It also attempts to simplify the tax code by eliminating most, if not all, tax deductions with the exception of the deductions for mortgage interest and charitable gifts, as well as repealing the alternative minimum tax and the estate tax. Finally, the Proposal calls for the repeal of the 3.8% tax on net investment income that was enacted under the Patient Protection and Affordable Care Act of 2010 (a/k/a Obamacare).

Business Tax Reform

Reduction in the Corporate Tax Rate - The Proposal lowers the federal corporate tax rate from 35% to 15% and makes the 15% rate available to businesses organized as passthroughs. The implication of the presentation by Mnuchin and Cohn is that the 15% rate for passthrough entities would either be an entity-level tax (with no tax on subsequent distributions to the entity's owners) or a cap on the tax imposed on the income allocated to the passthrough entity owners as opposed to a 15% entity level tax on the passthrough entity.

Territorial Tax System - The Proposal seeks to transition to a territorial tax system, whereby only income earned from activity within the United States is taxable. Currently, U.S. corporate taxpayers pay U.S. income tax on their global profits, with a deferral of tax for most active business income earned overseas by foreign affiliates. The Proposal provides that the purpose of the territorial tax system is to "level the playing field for American companies."[3]

Repatriation Tax – The Proposal reiterates the position taken by the President during his campaign that a one-time tax will be imposed on all foreign accrued profits regardless of whether the profits are actually repatriated to the United States. Once this "deemed repatriation" occurs and the tax is paid, the taxpayer can repatriate the profits to the United States without paying additional federal income tax.

Elimination of Tax Breaks - The Proposal does not provide specifics, but simply states that the Proposal will: "Eliminate tax breaks for special interests."[4]

Other Considerations – The Proposal does not address whether the Trump administration supports the border adjustment tax - a tax on all goods imported into the United States and an exclusion from taxable income for revenue from exports –

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[1] 2017 Tax Reform for Economic Growth and American Jobs.
[2] Note that the Proposal is relatively vague and the prospects for its passage by Congress are unclear at this time; these multistate tax considerations are described in the context of the Proposal concepts being ultimately enacted.
[3] 2017 Tax Reform for Economic Growth and American Jobs.
[4] *Id.*

or the immediate expensing of all business investment costs paired with a limitation on the deductibility of net interest expense, as set forth in the House Republican tax reform blueprint. The Proposal also does not stipulate the tax rate that would be applied to the deemed repatriations of foreign source income (during the campaign, candidate Trump suggested levying a 10 percent rate on such amounts). Additional consideration and discussion is likely to occur around both topics.

Multistate Tax Considerations

The potential implications of tax reform go beyond federal taxation. Below is a summary of some key considerations from a multistate perspective:

- ***Rate Reduction*** - With the potential reduction of the federal tax rate from 35% to a rate that may be as low as 15%, state corporate income taxes will become a more significant factor in corporate taxation. States are not required to reduce their tax rates, and many states are facing budgetary pressures that may weigh against a corporate income tax rate cut.
- ***Expansion of the state tax base*** - Under the Proposal, the federal tax base could become much broader as most tax deductions may be eliminated. This would ultimately lead to an expansion of the state tax base because many states conform (to varying degrees) to the federal definition of taxable income. As stated above, while the federal changes include rate cuts to offset the broader base, it is uncertain whether states would take a similar approach; due to budget pressures, it is possible that many states would not cut their rates.
- ***State Non-Conformity of the Internal Revenue Code ("IRC")*** - Generally, states conform to the IRC as of a specific date (i.e. "static" conformity). When tax reform occurs, a situation could arise where states that have static conformity require that federal taxable income be determined under the pre-tax reform IRC. Even in states that conform to the IRC, the states may de-couple from key provisions that have the potential to erode the state tax base.
- ***Repatriation*** - If repatriation is not included in federal taxable income, but rather is treated as a separate taxable item, questions arise as to how it will be taxed by the states. Which entity in the federal affiliated group will be the "deemed recipient" of the "deemed repatriation"? Will the repatriation of income be treated as a dividend, as a new category of miscellaneous income reported on a new subsection of Line 29 of the federal Form 1120, or a line 1 gross receipt? What will be the apportionment factor implications (i.e., will it be apportionable, allocable or potentially distortive)?
- ***Negotiating credits & incentives on reinvestments*** - Initiating discussions with state economic development agencies should be considered to assess incentives packages related to re-investment of funds into the United States. Given the potential magnitude of the repatriation of foreign profits (untaxed foreign profits held overseas by U.S. corporate taxpayers are estimated to exceed $2 trillion), many taxpayers may use these funds on capital expenditures and/or increase labor force and states are proactively competing to attract businesses.
- ***Territorial System*** - While it is still unknown how states would respond in a territorial system, companies should re-assess their filing methodologies for state tax purposes, and determine whether it is advantageous to file a "water's-edge" election or file on a worldwide basis. Additionally, companies that have had historical international planning structures, may assess the state impact of such structures, in any analysis related to "unwinding" such structures. This would be of particular relevance in states that have worldwide reporting or if states propose legislation to mandate worldwide reporting.
- ***Settling audits resulting in liabilities*** - To the extent there is a reduction in the federal tax rate, the resolution of state tax audits prior to the reduction which result in payments may yield a permanent tax rate benefit. Because negotiating a resolution can be a time-consuming process, consideration should be given to initiating discussions with the applicable taxing authorities as soon as practical.
- ***State reporting of federal RAR changes*** - For similar reasons as the last (and prior to the reduction of the federal tax rate), consideration should also be given to accelerating the reporting/payment of federal RAR changes in those states where a liability may result.

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