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External Multistate Tax Alert
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Tax Cuts and Jobs Act (H.R. 1) – Multistate Tax Considerations

Overview

On November 2, 2017, the Ways and Means Committee of the U.S. House of Representatives (the "Committee") released its first draft of its long-awaited tax reform legislation, the "Tax Cuts and Jobs Act" (the "TCJA").[1] While this legislation is the subject of intense lobbying and its passage is far from guaranteed (even if significantly amended), it represents a major step in the efforts of the Republican leadership in Congress and the Trump administration to enact sweeping changes to the Internal Revenue Code.

While the TCJA is a legislative effort to substantially revise and reform the federal Internal Revenue Code, many of its proposed changes will be of critical importance to state governments across the country. The TCJA contains certain proposed changes (e.g., the reduction in the corporate tax rate from 35% to 20%) that may encourage taxpayers to make federal elections between now and the end of their tax year to capitalize on timing differences, for which the state tax consequences should be considered. In addition, many of these changes can be expected to affect the calculation of federal taxable income, which is used by numerous states as the starting point for calculating state taxable income. Finally, several of the provisions contained in the TCJA are designed to stimulate investment in the U.S. economy, which can also have a significant impact on the states.

While the TCJA contains an extensive list of proposals, this tax alert highlights the federal income tax elements of the TCJA that are likely to generate significant interest for businesses and provides an overview of the associated multistate tax considerations.

Business Tax Reform

Reduction in the Corporate Tax Rate - The TCJA proposes several reduced tax rates, including:

- Corporate income tax rate: Flat rate of 20%
- Non-compensatory business income of pass-through entities: 25%[2]

These provisions both would go into effect in 2018. Accordingly, it is reasonable to expect federal income taxpayers to seek to accelerate deductions and defer income in order to capitalize on these declining rates. While these declining federal rates will not have a direct impact on applicable state rates, taxpayers should evaluate how any such expense acceleration or deferral of income would impact any deferred state tax assets they may have. Also, taxpayers should consider whether they have any state tax expense they could reasonably accelerate to the 2017 tax year (e.g., entering into a voluntary disclosure agreement by which a payment of state taxes would be made in 2017) should the federal rate reduction be enacted. Taxpayers should also evaluate whether states will conform to any federal acceleration/deferral elections the taxpayer may be considering.

Limitation on Interest Expense Deduction - Section 3301 of the TCJA provides that a business taxpayer (regardless of entity form) will not be able to deduct net interest expense to the extent it exceeds 30% of the taxpayer's adjusted gross income. Section 3203 provides an exemption from this limitation for small businesses. We generally expect that states will conform to this change as it will generally increase the income tax base and many states have already demonstrated a

[1] H.R. 1, November 2, 2017.
[2] The 25% tax rate on pass-through income is subject to limitations and modifications. H.R. 1, § 1004. The TCJA provides that pass-through income from passive business activity is eligible for the 25% rate. Owners receiving net income derived from active business activity must apply a "capital percentage" (either a flat 30% rate or a formula, at the taxpayer's option) that limits the pass-through income subject to the 25% rate; the income is otherwise subject to ordinary individual income tax rates. Special rules will also prevent the characterization of wage income as pass-through income.

desire to limit taxpayers' ability to claim interest expense deductions (e.g., requiring interest expense add-backs on state returns). While at the federal level it may be possible that this limitation on the interest expense deduction may reduce the need for federal limitations on the federal interest expense deduction (e.g., the 385 Regulations), we would generally expect state scrutiny of interest expense deductions to continue.

Immediate Expensing - Section 3101 provides that the current 50% bonus depreciation amount provided by IRC § 168(k)(1)(A) will increase to 100% for property placed in service after September 27, 2017 and before January 1, 2023. The state tax issues presented by this proposal include:

- State conformity: Given that this proposal is estimated to reduce federal revenues by $25 billion from 2018 – 2027 and would have a corresponding impact on state revenues, state governments will need to determine if they can afford to conform to this change. Many states currently decouple from federal bonus depreciation, and this number may increase if full expensing is adopted. Decoupling could span a range of options at the state level, including a complete decoupling, retaining the current 50% limitation, or other state-specific modifications.
- State Credit and Incentive Opportunities: The proposal is designed to encourage investment in capital assets across the United States. Many states offer statutory credits as well as negotiated incentives for this type of investment. Taxpayers who may plan on making an investment to capitalize on the federal benefit from immediate expensing should consider whether any state and/or local incentives may be available prior to making the decision where to make this investment. These incentives are not limited to income/franchise taxes, but may include:
  - Sales and use taxes
  - Property taxes
  - Employment/payroll taxes
  - Non-tax incentives such as zoning and permitting assistance

Expansion of Section 179 Deduction - Section 3201 provides for an expansion of the current IRC § 179 deduction from $500,000 to $5 million and an increase of the phase-out from $2 million to $20 million. Many states already impose their own limit on taxpayers seeking to claim this deduction on their state tax returns, and we would expect that trend to continue.

Modification of Net Operating Losses - Section 3302 provides for the general elimination of most net operating loss (NOL) carrybacks and limiting the NOL deduction prospectively to 90% of the taxpayer's pre-NOL taxable income. Just as with the IRC § 179 expansion, most states already impose their own specific NOL deduction rules, and we would expect that practice to continue.

Various Other Base-Broadening Provisions - The TCJA contains many other base-broadening provisions which are beyond the scope of this alert. While we would generally expect the states to conform to these federal changes as effective tax increases that the states do not have to directly enact, it is possible that local interest groups could seek to preserve some of the provisions, as they currently exist, at the state level. The TCJA's proposals in this regard include but are not limited to:

- Limitation on like-kind exchanges under IRC Section 1031 (Section 3303);
- Contributions to capital may be taxable if contributed asset benefited from state and/or local incentives (Section 3304);
- Repeal of deduction for domestic production activities (Section 3306);
- Limitation on entertainment and similar expenses (Section 3307); and
- Reform of various federal business and energy credits, bond provisions, etc. (Section 3401 et seq.)

International Tax Reform

Some of the most far-reaching provisions contained in the TCJA pertain to the U.S. taxation of foreign operations. These changes include, but are not limited to:

Participation Exemption for Foreign Dividends - Currently, foreign income earned by a foreign subsidiary of a U.S. corporation would not be subject to federal income tax until the income is distributed as a dividend to the U.S. corporation. Section 4001 of the TCJA proposes to exempt 100% of the foreign-sourced portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the foreign corporation. States that tax foreign dividends will need to consider the cost of conforming to this change.

Transition Tax/Deemed Repatriation - Under Section 4004 of the TCJA, U.S. shareholders owning at least 10% of a foreign subsidiary would include as Subpart F income the shareholder's pro-rata share of the foreign subsidiary's net post-1986 historical earnings and profits (E&P), as determined as of November 2, 2017, or December 31, 2017, whichever is higher. This income would be reported as of the foreign subsidiary's last tax year beginning before 2018. This income would be taxed at one of two rates:

- 12% for E&P held as cash or cash equivalents; and
- 5% for all other E&P.

This deemed repatriation is subject to several complex adjustments (e.g., netting E&P surpluses and deficits). However, the deemed repatriation raises a number of key state issues, including whether and how the respective states tax Subpart F income. The idea behind the deemed repatriation is that once the federal tax is paid on the deemed repatriation, the actual repatriation of these amounts will be tax-free at the federal level. One important issue for state taxpayers to consider is, to the extent a particular state has not taxed the deemed repatriation, will such a state attempt to tax the funds upon their actual repatriation? Another issue for state taxpayers to consider is whether a taxpayer has already paid state income tax on any of this E&P (e.g., by filing a worldwide state income tax return) and, if so, whether this provides a basis to avoid state taxation of the deemed repatriation.

It is also anticipated by the proponents of the TCJA that a substantial portion of the E&P subject to the deemed repatriation will be repatriated to and reinvested in the American economy. This proposal works in conjunction with the proposal to allow for immediate expensing for five years discussed above. Accordingly, taxpayers who anticipate repatriating and reinvesting a substantial amount of E&P following the deemed repatriation should consider state and local credits and incentives opportunities for such reinvestment.

Current Taxation of Foreign High Returns - Section 4301 of the TCJA proposes that a U.S. corporation be subject to current taxation on 50% of the U.S. corporation's "foreign high returns." These high returns will be the excess of the U.S. corporation's foreign subsidiaries' aggregate net income over a benchmark rate of return (e.g., 7% plus the Federal short-term rate). This provision is intended to prevent erosion of the U.S. tax base. The states, particularly those that currently use a water's edge filing group, will need to determine whether conforming to this change would result in a net benefit or a net cost to the state budget, keeping in mind such state-specific issues as formulary apportionment.

Excise Tax on Payments to Related Foreign Corporations - Section 4303 of the TCJA proposes to impose a 20% excise tax on payments (other than interest) by a U.S. corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset. This tax would not apply if the related foreign corporation elects to treat the payments as income effectively connected to a U.S. trade or business ("ECI"). Many states already limit a taxpayer's ability to deduct certain payments associated with intangible assets. If foreign corporations elect to treat these payments as ECI, taxpayers will need to evaluate where these foreign entities have nexus and how such payments will be apportioned. States may also consider whether this approach to related party transactions is more effective than the current efforts to limit deductions for related party transactions.

Taxpayer Considerations

While the foregoing is not an exhaustive list of all state tax issues raised by each proposal contained in the TCJA, the summary is intended to provide an overview of the range of state and local tax issues that presented by the TCJA. Each taxpayer is encouraged to consider these state and local issues when evaluating the impact of the TCJA on current and prospective tax planning.

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