EXTERNAL Multistate Tax Alert
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Tax Reform Framework – Multistate Tax Considerations

Overview

On September 27, 2017, the "Big Six,"[1] unveiled their tax reform framework (the "Framework"), which will serve as a template for the tax-writing committees that will ultimately draft tax legislation.[2]

This tax alert highlights the federal income tax elements of the Framework and provides an overview of the associated multistate tax considerations.[3]

Individual Tax Reform

As it relates to individuals, the Framework provides tax relief by reducing the seven current income tax brackets that range from 10% to 39.6% to three brackets of 12%, 25% and 35%. An additional – unspecified – top rate may also be implemented to tax high-income taxpayers. Further, the Framework nearly doubles the standard deduction (but eliminates personal exemptions), enhances the child tax credit and provides a credit for non-child dependents, repeals the alternative minimum and estate taxes, and eliminates most itemized deductions with the exception of the deductions for mortgage interest and charitable gifts.

Business Tax Reform

Reduction in the Corporate Tax Rate - The Framework lowers the federal corporate tax rate from 35% to 20%. It also limits the maximum tax rate applied to "small businesses" organized as pass-throughs to 25% and provides that rules will be promulgated to prevent high income individuals from manipulating income to utilize this rate. The Framework does not, however, provide guidelines for such anti-abuse rules, though in the past Secretary Mnuchin has said that the lower rate will not be available for professional services income. Additionally, the Framework proposes eliminating the corporate alternative minimum tax, though no mechanism is specified for dealing with existing AMT credits, and it leaves the door open for a corporate integration proposal to reduce the double taxation of corporate earnings.

Expensing of Capital Investments – The Framework allows businesses to expense "the cost of new investments in depreciable assets other than structures made after September 27, 2017, for at least five years."[4]

Interest Expense – For C corporations, the deduction for net interest expense will be "partially limited" and the Framework proposes that the tax committees adopt similar rules for interest paid by non-corporate taxpayers.

Elimination of Tax Breaks – While only specifically naming the Domestic Production Activities Deduction (i.e., Internal Revenue Code Section 199), the Framework indicates that numerous other deductions and special exclusions will also be repealed or restricted. Excluded from repeal, however, are the research and development and low-income housing credits.

Territorial Tax System – The Framework proposes to transition to a territorial system for taxing income earned by foreign subsidiaries of U.S. multinationals. Specifically, it provides a 100% exemption for dividends from foreign subsidiaries in which the parent owns at least a 10% stake. However, to prevent US base erosion, the Framework also proposes a "reduced" tax rate on current profits earned by foreign affiliates of U.S. multinationals. Currently, U.S. corporate taxpayers

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[1] The "Big Six" consists of Senate Majority Leader Mitch McConnell, R-KY, Senate Finance Chairman Orrin Hatch, R-UT, House Speaker Paul Ryan, R-WI, House Ways and Means Chairman Kevin Brady, R-TX, Treasury Secretary Steven Mnuchin and National Economic Council Director Gary Cohn.
[2] Unified Framework for Fixing Our Broken Tax Code, September 27, 2017.
[3] Because the Framework is relatively undetailed and the prospects for its passage by Congress are unclear at this time, these multistate tax considerations are described in the context of the Framework concepts being ultimately enacted.
[4] Unified Framework for Fixing Our Broken Tax Code, September 27, 2017.

pay U.S. income tax on their global profits when received through operating branches, as dividends from corporations or if subject to certain anti-deferral rules under subpart F.

Repatriation Tax – As part of the transition to a territorial system, the Framework proposes a one-time deemed repatriation tax on accumulated foreign earnings. The proposal suggests the tax would be imposed at one of two rates – one for earnings held in cash or cash equivalents and another (presumably lower) for accumulated foreign earnings held in illiquid assets – and would be payable over an unspecified period.

Multistate Tax Considerations

The potential implications of tax reform go beyond federal taxation. Depending on the provisions of a final tax reform legislative package, the multistate tax consequences of the proposals contained in the Framework may be sweeping in scope in terms of both the taxpayers and the state and local tax regimes affected. Below is a summary of some key considerations from a multistate perspective and how those considerations have changed since the Trump administration released its one-page fact sheet on April 26, 2017 (the "Proposal"):

- ***Rate Reduction –*** The Proposal recommended lowering the corporate tax rate to 15%, while the Framework provides for a reduction of the federal tax rate to 20%. In either case, state corporate income taxes will become, proportionately, a more significant factor in corporate taxation. Further, states are not required to reduce their tax rates.
- ***Expansion of the state tax base*** – Under both the Proposal and the Framework, the federal tax base could become much broader as certain tax deductions/incentives may be eliminated (e.g., repeal of IRC Sec. 199 deductions.) It is generally expected this may lead to an expansion of the state tax base because many states conform (to varying degrees) to the federally-defined tax base. While the federal changes include rate cuts that offset the broader base, it is uncertain whether states would take a similar approach.
- ***Pass-through Entity Tax Rate*** – The Proposal was ambiguous regarding whether the 15% business tax rate would apply to pass-through entities, but the Framework specifies a maximum tax rate of 25% on pass-through income. The Framework also provides that the tax-writing committees will draft anti-abuse rules to prevent pass-through owners from recharacterizing wage income as business income to avoid paying higher individual tax rates. To the extent a rate change and other reforms increase the use of pass-throughs, it could lead to increased tax collections by the states that impose entity-level taxes on pass-throughs (e.g., Ohio, Washington state) as well as increased complexity for pass-throughs filing composite returns and paying entity-level withholding on behalf of their owners.
- ***Repeal of the Personal Income Tax Deduction for State and Local Taxes –*** Although the Framework does not explicitly address the personal income tax deduction for state and local taxes paid, members of the Big Six have indicated that this current-law provision should be repealed in order to offset the cost of rate cuts and other tax relief and to simplify the code. Eliminating the deduction is among the most significant and controversial issues in tax reform as it raises a substantial amount of revenue but the burden of eliminating the deduction would be primarily borne by individuals with filing obligations in high-tax states, cities and counties.

The following multistate tax considerations are also applicable, but remain unchanged from the Proposal:

- ***State Non-Conformity to the Internal Revenue Code –*** Many states conform to the IRC as of a specific date (i.e. "static" conformity) while others have "rolling" conformity (i.e., a state automatically adopts provisions of the IRC as they are enacted). 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 for some period. States that otherwise conform to the IRC may decide to decouple from key provisions that have the potential to erode the state tax base. One example would be non-conformity to the capital expensing proposal.
- ***Repatriation*** - If deemed 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 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)?
- ***Credits & incentives on reinvestments -*** Given the potential magnitude of the repatriation of foreign profits, many taxpayers may use these funds domestically on capital expenditures and/or increased labor force. Exploring incentives packages related to re-investment of funds into the United States should be considered as states continue to compete to attract businesses.
- ***Territorial System -*** While it is still unknown how states would respond to a territorial system, companies should consider reassessing their filing methodologies for state tax purposes, and determine whether it is beneficial to file on a "water's-edge" or worldwide basis.
- ***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 under the higher current year federal tax rate. 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 Revenue Agent Reports ("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 (and otherwise agreed-upon federal adjustments in instances where a final RAR has yet to be issued) in those states where a liability may result.

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