Back to the Future of Federal Tax Reform?
*The State Tax Implications*

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Agenda

- Background on Tax Reform
- State Tax Conformity
- State Tax Implication of Specific Federal Provisions
- Fiscal Impact on the States
- Back to the Future: 1986 Tax Reform
- What Now?
Background on Tax Reform

General Overview of the Proposed Plans

— Two proposals: President Trump’s plan and the House Blueprint

— Both proposals reduce corporate income tax rates dramatically by consolidating the current seven brackets into three rates
  • 12%, 15%, and 33%

— Both proposals nearly double the standard deductions
  • House GOP Blueprint: $6,300 for singles up to $12,000
  • Trump’s plan: doubles the standard deductions

— Itemized deductions are eliminated in both plans, except mortgage interest and charitable giving deduction
  • Eliminates the state and local taxes paid deduction

— Both proposals lower the corporate income tax rate
  • House GOP Blueprint: rate of 20% with a “destination-based cash-flow tax”
  • Trump’s plan: rate of 15% with a territorial system
Background on Tax Reform

Why Now?

— U.S. tax rates and structures are no longer internationally competitive.
  • Worlds highest top marginal corporate income tax rates in the world.
  • Top marginal tax rate on labor.

— Other issue influencing federal tax reform:
  • Balance of power,
  • Federal budget deficits, and
  • Global tax security.
State Tax Conformity
State Tax Conformity

Why Conform?

- States rely on federal tax code because:
  - Simplifies filing for taxpayers,
  - Ease of compliance,
  - Eases administrative burden, and
  - Availability of information.

- Biggest consequences of non-conformity:
  - Increased complexity, and
  - Decreased compliance.

- States generally conform to federal individual income and corporate income.
State Tax Conformity

State Impact

— Two ways a state can conform, static or rolling.
  • About half use static, meaning they conform as of a specific date.
  • About half use rolling, meaning changes are adopted as they occur.

— States conform to federal individual income and corporate income.
  • Individual Income:
    • 27 states conform to federal adjusted gross income
    • 6 states conform to federal taxable income
    • 3 states conform to federal gross income.
  • Corporate Income:
    • 41 states conform to corporate income.
State Tax Conformity

Note: States conform to the federal tax code on either a static or rolling basis. Static conformity means conforming to the Internal Revenue Code (IRC) as of a specific date, such as January 1, 2016. Rolling conformity means adopting IRC changes as they occur.

*Gross receipts taxes are not comparable to corporate income taxes. Michigan taxpayers have the choice of rolling conformity or the tax code as of January 1, 2012. Maryland has rolling conformity unless the Comptroller finds a revenue impact of greater than $5 million.

Source: Bloomberg BNA

Source: Tax Foundation
# State Tax Conformity

## State Corporate Income Tax Conformity

<table>
<thead>
<tr>
<th>State</th>
<th>Corporate Conformity</th>
<th>Corporate Income Starting Point</th>
<th>Allow Section 179</th>
<th>Allow Bonus Depreciation</th>
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<tbody>
<tr>
<td>California</td>
<td>Jan. 1, 2015</td>
<td>Federal Taxable Income Before NOL and Special Deductions</td>
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<td>No</td>
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<tr>
<td>Conn.</td>
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<tr>
<td>Mass.</td>
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<td>New Jersey</td>
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<td>Federal Taxable Income Before NOL and Special Deductions</td>
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<td>No</td>
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<tr>
<td>New York</td>
<td>Rolling</td>
<td>Federal Taxable Income Before NOL and Special Deductions</td>
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<td>No</td>
</tr>
<tr>
<td>D.C.</td>
<td>Rolling</td>
<td>Federal Gross Receipts and Sales</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
State Tax Conformity

Timing Conformity Correctly

— Automatic adoption of tax reform for rolling conformity states.
  • Rolling states could decouple but may require them to call a special session.

— Fixed conformity states must update conformity date.

— Depending on when federal reform will be enacted, states may have to convene a special session to address changes.
  • States have short legislative sessions.
  • Typically states convene and adjourn during the first part of the year.
State Tax Implication of Specific Federal Provisions
State Tax Implications of Specific Provisions

— Income Tax Rate
  • Reduced federal corporate income tax rates likely not to have direct implications on the states.
  • State corporate income taxes are not computed as a percentage of federal tax liability.

— Income Tax Base
  • Broadened base: eliminate most deductions
  • Majority of base broadening would result from eliminating state and local tax deduction.
Immediate Expensing

- Both plans advocate for the acquisition of certain assets to be expensed immediately, reducing after-tax cost of business investments.
- Could affect federal taxable income and therefore affect computation of state taxable income.
- A state could decouple to avoid affects of immediate expensing (as most did with bonus depreciation).
State Tax Implications of Specific Provisions

– Deduction of Certain Interest Expenses Disallowed
  • House Blueprint allows for businesses to deduct interest expenses to the extent it is netted against interest income, allowing for carryforward indefinitely.
  • Computation of federal taxable income will be affected.
  • How it is implemented will affect the complexity: consolidated group level v. entity-by-entity.
State Tax Implications of Specific Provisions

— Net Operating Loss (NOL) Deductions
  • NOLs can be indefinitely carried forward (but not back) under the House Blueprint.
    • Limits NOL carryforward to 90%.
  • Majority of states use a specific NOL computation:
    • Carrybacks are disallowed in some states.
    • Some states deviate from federal carryforward period.
    • Likely that degree of non-conformity will decrease interest in conforming moving forward.
  • Tracking State NOL computations likely to continue to be difficult.
State Tax Implications of Specific Provisions

- Border Adjustable Tax (BAT) & Cash Flow Tax
  - House Blueprint moves to a consumption tax or a destination-based cash-flow tax.
    - Base of receipts minus purchases of goods and services from other firms minus compensation paid.
  - BAT offsets revenue impact of reduced federal tax rate, as it is one of the main revenue-raising provisions.
  - BAT will create a new tax base that could flow through to states that conform.
State Tax Implications of Specific Provisions

- Deferred Foreign Earnings
  - Both plans impose a one-time tax at a reduced rate on deferred foreign earnings of U.S. Companies.
    - Companies can pay tax over 8 years
  - State tax issues related to taxing worldwide earnings
    - Especially if a dividends-received deduction is used to accomplish repatriated earnings.
  - Consider:
    - Nexus,
    - Payee,
    - Treatment in combined reporting states,
    - Characterization as business or non-business income, etc.
State Tax Implications of Specific Provisions

— Territorial International Tax System
  • House Blueprint would impose tax on U.S. sourced earnings.
  • Allows for unlimited dividends received deduction for dividends from foreign subsidiaries.
  • Repeals Subpart F regime.
  • State impact is dependent on state treatment of foreign source income and foreign operations.
  • A number of states could be affected by repeal of Subpart F regime.
  • States that allow worldwide combined reporting will need examination.
State Tax Implications of Specific Provisions

— Other Proposals
  • Lower rate on pass-through income.
    • Consider unincorporated business taxes.
    • Dividends Paid Deduction proposal.
Fiscal Impact on the States
Overview

The federal government evaluates legislation and deficit-spends using a 10-year budget window.

- 10-year budget gives the federal government flexibility.
  - Full expensing is front-loaded and net interest deduction is back-loaded.

- Majority of states budget in a one or two year cycle with balanced budget requirements.

- States may see significant revenue increases if they conform to:
  - Border adjustability;
  - Disallowance of interest deductions;
  - Elimination of corporate tax deductions (but consider state tax deduction elimination);
  - Elimination of personal income tax deductions.

- After tax cost of state and local services would be increased by repeal of deduction for state and local taxes paid.
Fiscal Impact on the States

Factors Affecting Possible State Rate Decreases

- The state’s fiscal condition.
- The degree to which the state’s tax base is broadened and likelihood of distributing impact of potential rate changes.
- State’s ability and/or potential to decouple from specific federal provisions.
- Current state legislative and executive branches; their culture and philosophy.
- Requirement of state balanced budget. Many states are experiencing budget shortfalls.
Back to the Future: 1986 Tax Reform
1986: Last comprehensive federal tax reform.
- States moved toward the 1986 federal reform with projected increases in revenue.
- Focus was on rate reductions and base broadening.
- Gave states opportunity to consider ways to improve their own tax structures.
- States mainly mirrored federal reform.
- Large variation in revenue increase across the states.
Back to the Future: 2002

In 2002, less states supported federal reform.

- Congress accelerated depreciation rules.
- Both federal and state revenues dropped.
- 29 states limited or decoupled from the accelerated depreciation rule within one year of the change.
What Now?
What Now?

– Concurrent tax reform is being considered by states.
  • State legislators will not be stalled by federal tax reform.

– States may need to call special sessions to address implications of federal tax reform.

– States will struggle to analyze the effect of federal tax reform.
  • May delay state reactions.

– Phase-in, using tax triggers, of all federal reform. May result in an increased personal and corporate tax base.

– Unrealistic that states will reduce tax rates at the magnitude of the federal tax reform.
  • “Dynamic scoring” may be greatest unknown for states.
  • With Republican control of majority of state legislatures, there could be a push to decrease income tax rates.
Questions?