Discussion Topics

- Overview of Federal Tax Reform Proposals
- State Conformity: Where are we now?
- Preparing for Possible Tax Reform: What are states thinking and doing?
- Lessons from Kansas? Individual tax reform & pass-through income exemption
- Border Adjustment: What is the impact of Kraft?
- State Conformity to Eliminated Estate Tax
- State Impact of § 385 Debt-Equity Regulations
- State Impact of Federal Partnership Audit Reform
- Closing Observations
Overview of Federal Tax Reform Proposals
Introduction

- Republican party in control of the House, Senate and White House
- Tax reform listed as a high legislative priority, after Affordable Care Act (Obamacare) “repeal and replace”
- The House Republicans released their vision for tax reform on June 24, 2016 (the Blueprint)
  - No legislative language
  - No revenue projections
  - Purports to be revenue neutral
The Blueprint
Business Tax Reform

— **Business Tax**
  - Corporate rate reduced from 35% to 20%
  - Eliminate AMT
  - Immediate expensing of business investments
  - No deduction for net interest expenses
  - Net operating losses carried forward indefinitely

— **Destination-Based Cash Flow Tax**
  - Border adjustments

— **International Tax**
  - Move from worldwide to territorial tax system
  - 100% exemption for dividends from foreign subsidiaries
  - Unrepatriated foreign earnings would be subject to a 8.75% tax, if held in cash, or otherwise subject to a 3% tax

— **Pass-Through Businesses**
  - 25% capped tax rate
  - Permit deduction for compensation to owners of pass-through businesses
The Blueprint
Individual Tax Reform

— Reduce 7 tax brackets to 3 tax brackets (12%, 25%, & 33%)
— Eliminate AMT
— Increase standard deduction (approx. double):
  • $24,000 (joint)
  • $18,000 (head of household)
  • $12,000 (other)
— Eliminate all itemized deductions except mortgage interest & charitable contributions
— Eliminate estate tax
Beyond the Blueprint

— The House Blueprint contains few details regarding how these changes would be implemented

— Plans listed below are widely considered to be important sources for the Blueprint and offer more technical details:

• The 2005 President’s Advisory Panel on Federal Tax Reform (the President’s Advisory Panel)

• The American Business Competitiveness Act, introduced by Congressman Devin Nunes (R-CA) (the ABC Act)

• The Tax Reform Act of 2014, introduced by former Congressman Dave Camp (R-MI) (the Camp Proposal)
Trump’s Tax Plan

— On April 26, 2017, President Trump released his overall vision for business tax reform

— Goals for Tax Reform
  • Grow the economy and create millions of jobs
  • Simplify our burdensome tax code
  • Provide tax relief to American families — especially middle-income families
  • Lower the business tax rate from one of the highest in the world to one of the lowest

— Business Reform
  • 15% business tax rate
  • Territorial tax system to level the playing field for American companies
  • One-time tax on trillions of dollars held overseas
  • Eliminate tax breaks for special interests
Trump’s Tax Plan
Business Tax Reform

- **Business Tax**
  - Corporate rate reduced from 35% to 15%
  - Eliminates “tax breaks for special interests”

- **Pass-Through Businesses**
  - 15% capped tax rate

- **Destination-Based Cash Flow Tax**
  - Ignores border adjustments

- **International Tax**
  - Implements territorial tax system
  - One-time repatriation of offshore earnings (possibly subject to 10% tax)
Trump’s Tax Plan
Individual Tax Reform

- Reduce 7 tax brackets to 3 tax brackets (10%, 25%, & 35%)
- Eliminate AMT
- Double standard deduction
- Expenses & deductions
  - Provide “tax relief for child and dependent care expenses”
  - Eliminate targeted “tax breaks mainly benefiting the wealthiest”
  - “Protect the home ownership & charitable gift tax deductions”
- Eliminate estate tax
- Eliminate 3.8% “Obamacare tax that hits small businesses and investment income”
State Conformity: Where are we now?
State Independence from Federal Tax Law

– Due to state conformity with federal tax laws, changes at the federal level flow to state level.

– As a result, federal legislation may increase or decrease state tax revenues.

– States may diverge from federal tax law via state “decoupling” modifications.

– Taxpayers must separately track, monitor, and implement state modifications to federal provisions.
## State Impact Based on Conformity to Federal Tax Law

<table>
<thead>
<tr>
<th>Federal</th>
<th>States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate reductions</td>
<td>States have own rates</td>
</tr>
<tr>
<td>Broadened tax base</td>
<td>State conformity</td>
</tr>
<tr>
<td>Eliminated deductions</td>
<td>State conformity</td>
</tr>
<tr>
<td>Fully expensed investments</td>
<td>State conformity</td>
</tr>
<tr>
<td>Indefinite NOL carryforward</td>
<td>Limited application due to decoupling</td>
</tr>
<tr>
<td>Reduced repatriation rate</td>
<td>Modest impact</td>
</tr>
<tr>
<td>Territorial tax regime</td>
<td>Minimal conformity</td>
</tr>
<tr>
<td>Border adjustments (Blueprint)</td>
<td>Depends on implementation method</td>
</tr>
</tbody>
</table>
State Conformity to Federal Tax Law

- **Floating (or rolling) conformity** to the IRC automatically incorporates any changes to federal law.
  - No corresponding state law changes will be needed to conform to changes that Congress makes to the federal tax law.
  - 14 states with rolling conformity

- **Static (or fixed) conformity** to the IRC adopts federal law as of a certain date and does not encompass federal law changes enacted after that date.
  - States may be reluctant to automatically adopt federal changes without state legislative review.
  - 27 states with fixed date or partial conformity

- 5 states do not incorporate IRC by reference but use federal taxable income as starting point

- 4 states do not have a corporate income tax
To Conform or To Not Conform

Conformity Advantages

- Administrative ease
- Cost savings
  - Legislative and regulatory drafting
  - Compliance
  - Audit
  - Litigation
- Uniformity
- Simplicity of starting point

Conformity Disadvantages

- Cede tax autonomy
- Waiting on federal legislative action
- Does not reflect policy preferences of state voters
- Is not tailored to local needs
- Potentially adverse impact on state revenue base
Preparing for Tax Reform: What are the states thinking and doing?
Lessons from 1986 Federal Tax Changes?

- Some states cut their state tax rates to return new tax revenue
- Some states expanded deductions and exemptions
- Some states retained larger revenue
- Some states used federal tax reform as an impetus for their own reform
Lessons from 2002 Federal Tax Changes?


- States would incur a significant decrease in tax revenue by adopting the federal change.

- Majority of states reacted by “decoupling”
  - Within one year of the federal enactment, 25 states completely decoupled, 4 states limited the deduction, and only 16 states conformed.

- Similar impact as immediate expensing of business investments?
Not All Things Created Equal

– Impact of each piece of reform impacts states on an unequal basis

– State and Local Tax Deduction Elimination
  • Would force high-income filers, particularly in New York and California, to have the full effect of their states’ high marginal rates.
  • Current federal deduction diminishes the effects of high state rates.
  • California and New York receive approximately 1/3 of the deduction’s total value, and 6 states – California, New York, New Jersey, Illinois, Texas, and Pennsylvania – receive more than 1/2 of the value according to the Tax Foundation.
State and Local Tax Deduction Elimination

Recent study from the Government Finance Officers Association concludes that it would likely lead to a larger tax burden for all taxpayers who itemize deductions.

- Almost 30% of taxpayers, including individuals in every state and in all income brackets, would be adversely impacted.

<table>
<thead>
<tr>
<th>Adjusted Gross Income</th>
<th>Average SALT Deduction</th>
<th>Marginal Tax Rate</th>
<th>Est. Average Tax Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 10K</td>
<td>$115</td>
<td>10%</td>
<td>$12</td>
</tr>
<tr>
<td>10K to 25K</td>
<td>$234</td>
<td>15%</td>
<td>$35</td>
</tr>
<tr>
<td>25K to 50K</td>
<td>$770</td>
<td>15%</td>
<td>$116</td>
</tr>
<tr>
<td>50K to 75K</td>
<td>$2,146</td>
<td>15%</td>
<td>$322</td>
</tr>
<tr>
<td>75K to 100K</td>
<td>$3,948</td>
<td>25%</td>
<td>$987</td>
</tr>
<tr>
<td>100K to 200K</td>
<td>$8,395</td>
<td>28%</td>
<td>$2,192</td>
</tr>
<tr>
<td>200K to 500K</td>
<td>$20,901</td>
<td>33%</td>
<td>$6,780</td>
</tr>
<tr>
<td>500K to 1M</td>
<td>$49,102</td>
<td>35%</td>
<td>$19,444</td>
</tr>
<tr>
<td>1M+</td>
<td>$235,232</td>
<td>40%</td>
<td>$93,152</td>
</tr>
</tbody>
</table>

Impact on Budget and Economy

Federal Budget and Economy

<table>
<thead>
<tr>
<th></th>
<th>Trump</th>
<th>House GOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (change in level)</td>
<td>8.20%</td>
<td>9.10%</td>
</tr>
<tr>
<td>Wage Rate (change in level)</td>
<td>6.30%</td>
<td>7.70%</td>
</tr>
<tr>
<td>Full-time Equivalent Jobs (in thousands)</td>
<td>2,155</td>
<td>1,687</td>
</tr>
<tr>
<td>Static Revenue Impact (in billions)</td>
<td>($5,906)</td>
<td>($2,418)</td>
</tr>
<tr>
<td>Static Revenue Impact (percent)</td>
<td>-14%</td>
<td>-6%</td>
</tr>
</tbody>
</table>

Tax Foundation Taxes and Growth Model, March 2016

- Trump plan revenue reduction over 10 years: $5.9 trillion
- Blueprint revenue reduction over 10 years: $2.4 trillion
  - Revenue loss would decrease over time due to transition effect resulting in more lose in the earlier years
Alternatives to State Corporate Income Tax?

— **Nevada Commerce Tax**
  • Commerce Tax, effective July 1, 2015 (S.B. 483), is imposed on all business entities engaged in a business in Nevada, including pass-through entities, with over $4 million Nevada gross revenue.

— **2017 Proposals**
  • **Oregon:** Multiple gross receipts tax proposals following the failure of Measure 97 in November, including:
    • L.C. 3548, a legislative referendum to amend the Oregon Constitution to create a new Business Privilege Tax on all Oregon business entities at a maximum 0.7% rate.
    • The -2 amendment to H.B. 2830, released June 12, 2017, which would impose a commercial activities tax (CAT) on all business entities, including partnerships and S corporations.
  • **Louisiana:** Governor’s Tax Reform Plan proposed a CAT modeled after Ohio’s CAT to address $1.3 billion deficit. The bill, H.B. 628, was ultimately withdrawn by its sponsor after extensive negative testimony.

— Other states considering a gross receipts tax, including Oklahoma and West Virginia
Oklahoma Decouples from Federal Standard Deduction

- Oklahoma conforms to the IRC on a rolling basis
- On May 15, 2017, H.B. 2348 passed, which will decouple the state standard deduction from the current federal standard deduction
- Estimated to generate $4.4 million in revenue in 2018
- State has approximately $900 million budget shortfall
NYDOR and MADOR report seeing a reductions in estimated tax payments.

“[O]ne reason could be that taxpayers are holding off on taking capital gains while they wait to see if they will be able to pay a lower tax rate next year.”
An Unscientific Survey of the States

1. Which of the following best describes the current level of activity in your DOR with respect to the discussions of and proposals for federal tax reform?

   A. Low to no activity: we are taking a “wait and see” approach until an actual bill is filed or there is some other indication Congress will do something that affects our state.

   B. Medium activity: we are doing some research and spending some time and resources to understand the proposals and educate ourselves, but it is not a high priority.

   C. High activity: we are engaged in revenue modeling or other activities to determine how our state will be impacted; we are concerned that our state could be affected, or already is being affected, by federal tax reform.

   D. Other – please explain:

2. Please share any thoughts, concerns, or questions you have about the possibility of federal tax reform and how it might impact your state revenues or tax system.
And the Survey Says:

Question 1 – Level of Activity:
• Currently low to medium, leaning to the “wait and see” end of the spectrum.
• More activity earlier when it looked like things would move.

Question 2 – Concerns:
• Impact on revenues depending on degree of conformity.
• Will major federal law changes require major state law changes.
Lessons from Kansas?
Individual Tax Reform & Pass-through Income Exemption
The Blueprint
Pass-Through Entities

— Currently, the income from pass-through entities like partnerships and LLCs, as well as sole proprietorships, is included in the taxable income of the owner(s) for that year.

— The Blueprint would limit the tax rate on pass-through-entity income to 25%.

— The Blueprint also would permit deductions for compensation to owners of pass-through businesses, and such compensation would be taxed at the rate of 12%.

— It is unclear whether these proposals will be limited to small businesses only.
Lessons from Kansas’ Budget Cutting Experiment?
2012 Tax Cut Package

– Governor Sam Brownback (R) made cutting taxes and shrinking government the centerpiece of his administration.

– On May 22, 2012, the Governor signed H.B. 2117 into law, which included:
  • Reducing income tax rates and broadens base for individuals
  • A pass-through income exemption for individuals

– Forecasted $4.5 billion cumulative tax reduction over 6 years
  • State individual income tax brought $2.7 billion in 2011
Lessons from Kansas’ Budget Cutting Experiment?
H.B. 2117 – Reduced Income Tax Rates & Broadened Base

- Increased standard deduction
  - Head of household: $4,500 to $9,000
  - Married couple: $6,000 to $9,000

- Eliminates several credits:
  - Tax credit to offset sales tax paid on groceries
  - Adoption tax credit
  - Alternative fuel equipment tax credit
  - Child care tax credits
  - Low-income property tax credit for renters

<table>
<thead>
<tr>
<th>Previous Rates</th>
<th>HB 2117 Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate</td>
<td>Single</td>
</tr>
<tr>
<td>----------------</td>
<td>-------</td>
</tr>
<tr>
<td>3.5%</td>
<td>$0</td>
</tr>
<tr>
<td>6.25%</td>
<td>$15,000</td>
</tr>
<tr>
<td>6.45%</td>
<td>$30,000</td>
</tr>
</tbody>
</table>
Lessons from Kansas’ Budget Cutting Experiment?
H.B. 2117 – Pass-Through Income Exemption

— Individuals can subtract from federal AGI
  • All schedule “C” income
  • Income from partnerships, S Corps., rental real estate, royalties, etc.
  • Farm profits

— Individuals cannot subtract from federal AGI
  • Wages
  • Interest, dividends, capital gains
## Lessons from Kansas’ Budget Cutting Experiment?
H.B. 2117 – Pass-Through Income Exemption (cont’d)

<table>
<thead>
<tr>
<th>Facts</th>
<th>Kansas Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plumber earns $200,000 operating as a sole proprietorship and reporting business income on Schedule C</td>
<td>$0</td>
</tr>
<tr>
<td>Plumber earns $200,000 operating as a DRE, partnership or S-Corp</td>
<td>$0 for Entity $0 for Plumber</td>
</tr>
<tr>
<td>Plumber’s apprentice earns $50,000 in wages working for plumber</td>
<td>$50,000</td>
</tr>
<tr>
<td>C-Corp makes $200,000 operating a plumbing business and does not issue a dividend</td>
<td>$200,000</td>
</tr>
<tr>
<td>C-Corp makes $200K operating a plumbing business and dividends the earnings to its sole shareholder who resides in Kansas</td>
<td>$200,000 for Entity $200,000 for Shareholder</td>
</tr>
</tbody>
</table>
Lessons from Kansas’ Budget Cutting Experiment?
Aftermath - Revenues dropped & steep budget cuts

– 2016 growth rate:
  • Kansas: 0.2%
  • Rest of the country: >2%

– 9 rounds of budget cuts over 4 years

– 3 credit downgrades

– Missed state payments

  • $500-$800 million in estimated annual additional funding needed
Lessons from Kansas’ Budget Cutting Experiment?
Aftermath – Legislative Override

– June 5, 2017: Kansas House & Senate passed S.B. 30:
  • Raise individual income tax rates:

<table>
<thead>
<tr>
<th>HB 2117 Rates</th>
<th>SB 30 Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate</td>
<td>Single</td>
</tr>
<tr>
<td>3%</td>
<td>$0</td>
</tr>
<tr>
<td>4.9%</td>
<td>$15,000</td>
</tr>
<tr>
<td>Eliminated</td>
<td></td>
</tr>
</tbody>
</table>

• Retroactive repeal of pass-through carveout to January 1, 2017
• Re-enact several deductions and credits, e.g., mortgage interest, property taxes paid, and medical expenses deductions and child care tax credit (partial)

– June 6, 2017: Governor vetoed S.B. 30

– June 6, 2017: Kansas House & Senate overrode the Governor’s veto
Border Adjustment: What is the impact of \textit{Kraft}?
The Blueprint
Destination-Based Cash Flow Tax

— Currently, US corporations are subject to tax on their worldwide net income.

— The Blueprint would tax on a cash-flow, destination basis:
  • Products, services and intangibles that are exported would not be subject to US tax.
  • Products, services and intangibles that are consumed in the US would be subject to US tax, regardless of where they are produced.

— Effectively, corporations may exclude from their taxable income their overseas sales while deducting the wages and costs incurred in the US. However, imports are subject to tax on a gross basis with no corresponding deduction for wages and costs incurred outside of the US.

— The Blueprint does not address whether this switch would be immediate or gradually phased in.
State Conformity
Violates the Foreign Commerce Clause?

– Border adjustment favors domestic production & commerce over foreign production & commerce through the disparate treatment of the COGS deduction

– Potential Foreign Commerce Clause violation absent state action or decoupling under *Kraft v. Iowa Dep’t of Revenue*, 505 U.S. 71 (1992)
  • Foreign Commerce Clause prohibits a state from favoring domestic commerce over foreign commerce, even when the state is merely conforming to the federal tax treatment of the same activity
Kraft v. Iowa Dep’t of Revenue, 505 U.S. 71 (1992)

— Court held that Iowa violated the Foreign Commerce Clause when it allowed DRDs from domestic subsidiaries, but denied DRDs from foreign subsidiaries
  • Iowa’s disparate treatment was in conformity with the federal treatment of these dividends

— Court rejected Iowa’s argument that its discrimination was justified by a legitimate goal of promoting administrative convenience for taxpayers through federal and state conformity
State Conformity to Eliminated Estate Tax
State Conformity to Estate Tax

Prior to 2001, the federal government allowed a credit against the federal estate tax for state estate taxes, up of 16% of an estate’s value over the $5 million exemption amount. Every state took advantage of the credit to impose a “pickup” tax equal to the credit.

In 2005 the state credit was eliminated; since most states tied their estate taxes to the credit, many states eliminated their estate taxes; some decoupled or passed inheritance taxes.

The federal estate tax returned in 2010 but without the credit; estates were allowed a deduction for estate taxes, made permanent in 2014.
State Conformity to Estate Tax (cont’d)

– 14 states and the District of Columbia have an estate tax
– States rely heavily on the IRS to administer through use of federal estate tax audits and federal estate tax regulations and guidance
– Potentially increased cost of state tax administration for states
  • States would bear the full administrative burden if federal estate tax is eliminated
State Impact of § 385 Debt-Equity Regulations
IRC § 385 Regulations – Background

IRC § 385 was enacted as part of the Tax Reform Act of 1969

— Authorizes the Secretary of the Treasury to prescribe regulations that are “necessary or appropriate” to determine whether an interest in a corporation is to be treated as stock or debt

— IRC § 385(b) sets out certain factors to be considered in determining whether a debtor-creditor relationship exists:
  • Unconditional promise to pay in return for adequate consideration
  • Whether “debt” is subordinated to other debt
  • Issuer’s debt-equity ratio
  • Whether debt is convertible into issuer’s stock
  • Relationship between stock ownership and “debt”
IRC § 385 Regulations – Overview

On October 13, 2016, the IRS issued Final and Temporary Regulations under IRC § 385 (T.D. 9790)

These regulations are significantly narrower than the Proposed Regulations that were issued on April 4, 2016

- Documentation requirements were postponed and modified
- *Per se* equity rule was generally replaced by a presumption
- Bifurcation rule that would have allowed instrument to be recast as part equity and part debt was eliminated
- Generally exempt cash pools and short-term loans
- Generally exempt instruments issued by S corporations, RICs, REITs, foreign corporations and certain partnerships
- Modified indirect ownership rules to eliminate downward attribution
- Removed the cliff effect of the $50 million threshold exception for covered debt instruments
IRC § 385 Regulations – Overview

Here to Stay?

– On July 7, 2017, the Department of Treasury issued Notice 2017-38, which identifies 8 tax regulations for potential repeal or modification under President Trump’s executive order 13789, seeking tax code simplification.

– Included in the 8 targeted regulations are the final regulations under IRC § 385 (T.D. 9790).
IRC § 385 Regulations – Overview

- Reaffirm application of existing case law debt-equity principles
- Impose additional rules for related-party debt:
  - New documentation requirements
  - Equity recast rules for related-party debt issued in connection with certain transactions
- Generally applies to debt among members of an expanded corporate group, which includes certain controlled partnerships
- Will be most relevant to foreign-owned multinational groups that hold inbound debt of U.S. subsidiaries
- Regulations do not apply to:
  - Obligations issued by foreign corporations
  - Obligations between members of a consolidated group
- Consolidated group members are treated as a single taxpayer for purposes of applying the rules
Documentation Requirements

— Documentation requirements will not apply to debt instruments issued before January 1, 2018

— New documentation rules require that taxpayers prepare and maintain contemporaneous documents to support related-party debt:
  • E.g., loan documents, repayment analyses, ongoing payments
  • Documentation is timely if prepared by the time issuer’s federal income tax return is filed (with extensions)
  • If documentation requirements are not met, a presumption will exist that the debt is equity, rather than *per se* equity, as long as a high degree of compliance exists with respect to the documentation requirements
  • If documentation requirements are met, must still determine whether the instrument is debt or equity under case law or transaction rules

— Reasonable cause and ministerial error rules exist, with an opportunity to cure defects
Documentation Requirements

Documentation must demonstrate the essential characteristics of debt:

– Legally binding obligation to pay;

– Creditor’s rights to enforce the obligation;

– Reasonable expectation of payment at the time of creation, demonstrated by cash flow projections, financial statements, business forecasts, asset appraisals and other relevant financial ratios (compared to industry averages); and

– Payments of interest or principal or exercise of diligence and judgment of a creditor in the event of a default.
Equity Recast Based on Specific Transactions

Regulations allow the IRS to potentially treat certain related-party debt instruments issued in connection with certain transactions as equity:

- Designed to target specific transactions (e.g., intragroup note distributions and economically similar transactions)
- “Funding rule” also would treat as equity any related-party debt that is issued with a principal purpose of funding one of the specified transactions

**Diagram:

**Year 1**
- CFC 1 distributes a note to US Parent, treated as a return of capital
- US Parent
- CFC 1
- CFC 2

**Year 2**
- US Parent
- CFC 1
- CFC 2
- CFC 2 distributes cash to CFC 1, treated as a dividend

**Year 3**
- US Parent
- CFC 1
- CFC 2
- CFC 1 repays the note to US Parent
Consolidated Group Exception

Final and Temporary Regulations do not apply to debt instruments between members of a consolidated group

— Existing common law multi-factor debt-equity analysis continues to apply to these transactions

— To achieve this result, a consolidated group of corporations is treated as one corporation

— Transactions between different consolidated groups, or between a consolidated group member and a related foreign affiliate, could have unanticipated results
Consequences of Equity Characterization

- Related-party debt recast as equity under the Regulations would be treated as equity for all US tax purposes

- Equity characterization is expected to have consequences for the initial transaction, and for future transactions (e.g., repayment or exchange of instruments):
  - Interest expense deductions generally lost
  - Payments generally treated as dividends, potentially subject to different withholding tax treatment
Potential Implications for State Income Taxes

— Regulations are likely to impact state income taxes, particularly over the long term

— Direct impact
  • Any increase in a taxpayer’s federal taxable income resulting from the IRS’s application of the Regulations (e.g., reduced interest expense deductions on debt to foreign affiliates, or increased income from characterization of principal repayments as dividends) may have an associated state tax cost, because states generally adopt federal taxable income as the starting point for calculating the state tax base
Separate Reporting States

Separate company reporting states might seek to apply the Regulations as a tool to disallow interest deductions on intercompany debt

- States could seek to use their IRC conformity laws to argue that the Regulations also apply for state income tax purposes, because many states adopt most or all of the IRC through varying mechanisms
  - Separate company reporting states routinely apply the IRC and relevant IRS regulations “as if” each corporation had filed a separate federal tax return
  - If states apply this approach to the Regulations, states could potentially argue that the Regulations provide authority to reclassify intercompany debt as equity and thereby deny the related interest expense deductions

- Separate company reporting states may seek to adopt their own comparable regulations under other state law authority
Addback Statutes

- Many states have adopted statutes requiring interest deductions to be “added back” if the interest is paid to a related party, unless the taxpayer qualifies for an exception.

- Even where the addback statute does not apply, states could attempt to deny an interest expense deduction by applying the Regulations to treat the debt as equity.
  - This would be particularly relevant where a state’s addback statute applies narrowly (e.g., only to interest related to intangible assets).
Combined/Consolidated Reporting States

Regulations could impact taxpayers in states that require combined or consolidated reporting:

— Ownership percentages of subsidiaries could be changed by recast equity and result in a different composition of the combined/consolidated group

— Recast equity may cause federal/state stock basis differences
  • E.g., Sub dividends note to Parent, and state later recasts debt as equity. Payments from Sub to Parent may now be distributions rather than interest. Both may be eliminated in combination. However, if payments exceeded Sub’s E&P, Parent’s basis in stock of Sub may be reduced by distributions. When Parent later sells Sub, Parent may have higher gain for state purposes than federal

— Even if a state conformed to the consolidated group exception:
  • Would entities excluded from a state combined group (e.g., captive insurance company) qualify for the exception?
  • Would states extend the exception to all worldwide affiliates if the taxpayer files a worldwide combined return?
Franchise Taxes

Net-worth-based franchise taxes generally include equity in the tax base but exclude debt

– A recast from debt to equity for state income tax purposes may carry over from income for franchise tax purposes
IRC § 385 Regulations Meet the States

— Louisiana Proposed Regulation LAC 61:I.1115
  • Would require that the business purpose exception “be supported by contemporaneous documentation,” a requirement not found in the statute, and which is similar to the new federal Section 385 regulations; and
  • Would require interest expenses paid to an affiliate on “excess debt” to be added back to the extent the borrower/payer’s “debt over asset percentage exceeds the consolidated unrelated third party debt over asset percentage of its federal consolidated group”
    • Although the regulation provides that such interest expenses cannot qualify for unreasonable exception, it seems unclear how the “excess debt” limitation interacts with other exceptions like the conduit or business purpose exceptions
State Impact of Federal Partnership Audit Reform
Federal Partnership Audit Reform

Bipartisan Budget Act of 2015

– Includes federal partnership audit reform
– Generally applies to tax years beginning after December 31, 2017
– But certain elections can make it applicable right now
– Meant to simplify auditing partnerships and assessing liabilities – expected to raise $9.3 billion (over 10 years)
New Regime – Basic Rules

IRS may assess and collect from partnerships at the entity level for 1065 and Schedule K-1 issues
  • Collection **from partnership** (not partners) in “year of adjustment” rather than “year of review”

Option to elect out for partnerships with 100 or fewer partners
  • Partners cannot be other partnerships, LLCs (including SMLLCs), trusts or tax-exempt organizations
  • Audit, assessment and collection at partner level – “Back to the Future” – Pre-TEFRA
  • Election is the partnership’s (not the partners individually)
  • Who’s going to decide?
New Regime – Basic Rules

After assessment, partnerships (that can’t elect out) can:

- Modify the proposed entity level assessment by presenting information specific to partners’ taxes — including amended returns

- “Push out” the entity level tax liability by providing Schedule K type reports to partners for their share of the tax imposed at the partnership level – current year

- Cost: 2% higher interest rate
Regulations in the Works

- On January 20, 2017, the White House administration issued a memorandum ordering a regulatory freeze that extends to the proposed partnership audit rules
- On June 13, 2017, Treasury re-released proposed partnership audit rules (REG-136118-15) with minor revisions from the version released in January
Implications for the States

– Large financial market and production states (and venture capital markets) are likely to see the greatest impact

– Smaller and more rural states – partnerships are likely to be simpler, more closely held, investment partnerships (with real estate predominating) and less likely to have multistate implications
State Issues

– Will state law conform to the new federal changes?
  • Not automatically

– New federal rules are primarily in IRC §§ 6221 to 6241 (administrative procedures)

– States use the IRC only to compute taxable income and do not incorporate IRC administrative procedures
  • States usually have their own procedures

– Practitioners need guidance for dealing with partnership and operating agreements
State Issues

Without automatic adoption, where does that leave states?

- For partnerships assessed by the IRS at the entity level, how will states impose related state tax?
  - How are states to deal with the liability being assessed in “year of adjustment” rather than “year of review”?
  - Most states never conformed to TEFRA
Existing State Enforcement Mechanisms

Many states already use two types of enforcement mechanisms for nonresident partners:

• Impose withholding requirement on partnership for income passed through to nonresident partners (or nonresident partner consents to state taxation)
• Impose a composite filing requirement

Could states modify/expand these to require entity level audit liability remittance?
MTC Partnership Project

On September 27, 2016, in response to the new partnership audit regime, the Multistate Tax Commission (MTC) formed the Partnership Project.

The Partnership Project intends to address:

- Are new state statutes called for?
- What more should the states be doing to audit and track partnership income?
- Are withholding statutes effective enough given multiple tiered entities, and how will old statutes intersect with entity-level liability?
Closing Observations
Closing Observations

- The resolution of the Affordable Health Care Act debate will likely signal the fate of federal tax reform efforts. If AHCA legislation can be passed, it would demonstrate that the majority in Congress is unified enough and has the will to make significant changes in the face of opposition from key interest groups. If AHCA legislation fails, it suggests comprehensive tax reform would fail also.

- The House Blueprint would move the U.S. business income tax to a consumption-type tax. States would face greater difficulty in imposing business entity taxes and could move to gross receipts tax impositions.

- Territorial taxation would eliminate inversion trends but could exacerbate transfer pricing disputes.
Closing Observations (cont’d)

– Unclear if states would de-couple from proposal for 100% expensing of assets; 27 de-couple from accelerated depreciation in late 1987-1988. (Tax Foundation)

– States would face pressure to raise standard deduction amount if federal government did (only 12 states conform to federal amount by statute).

– Municipal and county associations are already fighting proposal to eliminate state and local tax deductions; about a third of deductions are attributable to property taxes.

– If federal estate taxes are repealed, states may adopt inheritance taxes because they would no longer have access to IRS valuations of properties.
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