STATE TAXES AFTER REFORM
PARTNERSHIP

Conforming to Federal Tax Reform = Business Tax Increase

Blindly Conforming to the Internal Revenue Code is NOT the Right Answer.

- For years–if not decades–business have supported State legislative efforts to conform to the federal corporate income tax. Conformity generally supports simplicity, eases administrative burdens for both business and States, and promotes compliance with State taxes.
- But the federal Tax Cuts and Job Act (TCJA) is *radically different*! The TCJA represents the biggest change in business taxes since the corporate income tax was initially created. It is fundamentally different than any corporate income tax system that has ever been imposed in the United States. Indeed, it is unique from a global perspective: no other country imposes a corporate income tax like the TCJA.

For Businesses, Conformity Without Modification is a SIGNIFICANT TAX INCREASE.

- The single most important fact to understand is that blind conformity to the corporate income tax changes imposed under the TCJA will ALWAYS result in a State tax increase absent a proactive response. The reason is simple. The federal government significantly reduced the corporate income tax rate, from 35% to 21% (a 40% reduction in the top rate), but at the same time broadened the tax base. *States which "conform" to the new, broader federal corporate income tax base, but which do not reduce rates, will automatically and significantly increase business taxes–by 12% on average.*

The RIGHT Answer is to Decouple from Federal Base Broadening Provisions.

- The overarching goal of the business tax reforms was to remove disincentives to invest and create jobs in the United States for all businesses. States which choose to conform to the broader corporate income tax base are instead imposing new barriers to investment and job creation. And although lowering state corporate income tax rates might sound like the right answer, it is not: the federal base broadening provisions mainly relate to *foreign* income, which is generally not subject to state taxation.
- Thus, for policymakers who support improving the economic climate and encourage investment and job creation, *the path forward is simple: decouple from the federal corporate income provisions which broaden the tax base.*

Federal Business Tax Reform: Guidelines for States

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Most States base their income tax codes on federal law, and thus the federal Tax Cuts and Job Act (TCJA) contains far-reaching policy implications for States. The crux of the federal reform was a fundamental change in business (corporate) taxes. The overarching goal of the business tax reforms was to remove disincentives to invest and create jobs in the U.S. for both U.S. and foreign businesses.

Issue: If States do not carefully examine and respond to the new federal system, they run the risk both of creating barriers to investment and job creation and of exposing themselves to costly and unnecessary litigation. Simply "conforming" to the business tax sections of the Internal Revenue Code (IRC) is not the right answer for States or their citizens.

Recommendations:[1] States should generally follow their current policies of avoiding taxation of non-U.S. income and encouraging investment and job creation. Specifically, States should:

- ***Decouple*** from the following IRC sections (i.e., *exclude* these sections from the state business tax base).
  - IRC sections 965(a) and 965(c) - the Repatriation Transition Provisions. These federal code sections are related to the transition from a "worldwide" to "quasi-territorial" tax system. Decoupling is consistent with policies to avoid taxation of foreign income.
  - IRC sections 951A, 250(a)(1)(B)(i)) - Global Intangible Low-Taxed Income ("GILTI"). This new code section relates only to foreign income. Decoupling is consistent with policies to avoid taxation of foreign income.
  - IRC section 163(j) - Interest Limitation Deduction. This provision provides no material benefit to States and would be extremely complex to impose, administer, and comply with at the State level.
  - IRC section 118 - Contributions to Capital. This provision would specifically contravene State policy goals by imposing taxes on States' own economic development incentives.
  - IRC section 162(r) - FDIC Fees. The federal provision disallowing a deduction for FDIC fees was included purely as a means of raising revenue to offset other provisions that reduced federal business taxes. There is no similar State business tax reduction, and thus there is no rationale for States to limit the deductibility of FDIC fees.

[1] These proposed recommendations are necessarily general in nature. Each State will need to carefully evaluate its existing laws to ensure the proper application of these recommendations. The STAR Partnership welcomes the opportunity to assist in the development of appropriate State-specific recommendations. Please contact Joe Crosby for further information.

- ***Conform*** (or couple) to the following IRC sections (i.e., *include* these sections in the state business tax base).
  - IRC section 250(a)(1)(A) - Foreign-Derived Intangible Income ("FDII"). This new code section removes disincentives for businesses that maintain intellectual property in the U.S. and use it worldwide. Conforming supports this important policy goal.
  - IRC sections 168(k), 179 - Expensing of Certain Assets. These code sections support investment in the U.S. Conforming supports this important policy goal.

- ***Ignore*** IRC section 59A - Base Erosion and Anti-Abuse Tax ("BEAT"). States are prohibited under the Constitution (Foreign Commerce Clause) from adopting this brand new federal provision.

Discussion: The TCJA moved business taxes from a worldwide system to a quasi-territorial system. The new system is closer to the global norm, under which businesses are taxed only on domestic income. In other words, under the new system, businesses are taxed principally on the income they earn in the U.S. regardless of where they are based.

The new system does include some elements of taxation of foreign income (hence it is quasi-territorial rather than truly territorial). Under the prior federal tax system, States generally did not include foreign income in their own tax bases, for both policy reasons and Constitutional limitations. States should continue to respect these policy and Constitutional rationales and avoid taxation of foreign income by excluding these provisions from their business tax bases.

Other provisions of the new federal system were adopted specifically to encourage investment in the U.S. and the use of U.S. intellectual property worldwide (rather than transferring such property to foreign affiliates). States should support these important policy goals by incorporating these provisions into their business tax bases.

About Us: The STAR (State Taxes After Reform) Partnership was formed to help the business community navigate the state legislative, executive, and regulatory reaction to federal tax reform. Please visit our website for more information about the STAR Partnership and our work (www.star-partners.org).