STATE TAXES AFTER REFORM
PARTNERSHIP

FAQs | Federal Tax Reform + State Tax Implications

General Conformity

***Question**:* Most states base the starting point of their corporate income tax system on the federal income tax base because such overlap results in efficiency and simplicity. Shouldn't states conform to most of the federal changes of the Tax Cuts and Jobs Act because of these efficiency and simplicity concerns?

***Answer**:* False. In many cases, conformity does generate simplicity. However, conforming to certain provisions of the Tax Cuts and Jobs Act – especially the GILTI, the deemed repatriation provisions, and the interest expense limitations – will generate more complexity.

> Inclusion of GILTI and deemed repatriated foreign earnings in the tax base raises issues concerning whether such inclusion is constitutional (which will breed uncertainty for the tax collected if litigation on such issue ensues), whether factor representation is necessary and, if so, how such factor representation will be implemented.
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> As for the interest expense limitation issues, separate interest expense limitation computations may be needed for each return filed in the state. In addition, significant resources will be needed to adopt rules addressing: whether carried forward interest expense will be based on taxpayer's apportionment in the year the interest expense is paid or in the year the interest expense is used; how to account for the suspended interest expense when a corporation leaves/joins a combined group; how to account for the interest expense when there is a change of ownership in the taxpayer; how to coordinate the interest expense limitations with any related-party interest add-back rules in the state; and whether to suspend the income inclusion if a disallowed business expense is paid to a related party that files a separate return or as part of a different filing group in the state.

Federal Tax Reform Benefits

Question*:* Isn't it true that corporations benefited greatly from federal tax reform, thus according states the freedom to obtain some of the tax benefits received from those corporations?

Answer*:* False. It may be true that corporate taxpayers have received benefits from federal tax reform, but the vast majority of the benefit has accrued to individual taxpayers, not to corporate taxpayers. Individual taxpayers are anticipated to have realized $1,338 billion in tax savings from federal tax reform (not counting estate tax savings of an additional $72 billion), while corporations have realized only $373 billion in tax savings from federal tax reform.[1] Clearly, corporate taxpayers have not been the big winner from federal tax reform that they are being touted to be; even more clearly, corporations did not receive a big windfall at the expense of individual taxpayers.

In addition, any savings that corporations did receive were granted in an effort to make the United States a more competitive environment for the operation of business activities. States should support the federal government in this initiative by supporting business generation provisions such as expensing.

GILTI

Question*:* Shouldn't the states include GILTI in their tax base because it is income that companies have generated overseas in low-tax jurisdictions by moving their mobile intangible assets to such low-tax jurisdictions in an attempt to avoid the imposition of US tax on such income?

Answer*:* False. GILTI itself is not income generated in low-tax jurisdictions overseas. Much of GILTI consists of income generated in high-tax jurisdictions through active business operations, sometimes even from companies that hold their mobile intangibles within the US. The federal government is able to target and tax the low-taxed portion of GILTI through the federal government's use of foreign tax credits -- essentially, tax is not paid for federal income tax purposes to the extent a credit is available for foreign taxes paid on GILTI. The states do not apply foreign tax credits and thus taxation of GILTI at the state level would result in the states imposing tax on income from active business operations that was also subject to tax overseas.

In addition, GILTI is supposed to operate on a combined basis with FDII -- with GILTI acting as a stick, providing an additional cost for companies holding their mobile intangibles outside of the US, and with

[1] Special Report: Preliminary Details and Analysis of the Tax Cuts and Jobs Act, The Tax Foundation ,December 2017, Table 5.

FDII acting as an incentive, providing a benefit to companies that relocate their mobile intangibles in such manner.

Interest Expense Limitation

Question*:* If the purpose of the interest expense limitation at the federal level is to dissuade companies from placing excessive interest expense in their US taxpayers, shouldn't the state follow that same policy, instead of allowing taxpayers to take excessive interest deductions?

Answer*:* False. States should not impose the interest expense limitation because many states already have their own methods for reducing excessive interest expense – through related party add backs and through transfer pricing – while the impact of the federal interest limitation at the state level may be meaningless.

In separate filing states, or states where the composition of the combined state group is different than the composition of the federal consolidated group, the interest expense limitation may be computed differently, with a very different impact, at the state level. For example, a related group of corporations (the "Related Group") that has no interest expense limitation at the federal level may have an interest expense limitation at the state level. This outcome may be the result of the different composition of the members comprising the federal consolidated group and the state combined group or, in separate filing states, the fact that the interest expense limitation will have to be determined on a stand-alone basis. Such differences can result in the individual corporation with the bulk of the interest expense incurred for the Related Group being separated from the corporation or corporations in the Related Group that generate profits or to which the interest expense is paid. Thus, computing the interest expense limitation on a separate basis for a member or members of the Related Group can result in an interest expense limitation being imposed even though there is absolutely no excessive interest expense for the Related Group in the US.

In other words, imposition of the interest expense limitation at the state level can result in random results that are in no way connected to the federal policy for imposing the limitation on interest expense deductibility. Accordingly, there is no reason to impose the interest expense limitation at the state level.