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NAVIGATING US TAX REFORM: WHAT BUSINESSES NEED TO KNOW

State and Local Tax Implications

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AGENDA

- State Implications of Corporate Tax Reform
- State Implications of Individual Tax Reform
- Q&A
- Conclusion

STATE TAX IMPLICATIONS OF CORPORATE TAX REFORM

Corporate Tax Issues

- Reduction to Federal Tax Rate
- State Conformity to the IRC
- State Reporting Methods
- Domestic Dividends Received Deduction – IRC 243
- Foreign Dividends and Deemed Repatriation of Earnings and Profits
- Interest Expense Limitation – IRC 163(j)
- Full Expensing of Certain Property – IRC 168
- Other Tax Considerations

Reduction to Federal Tax Rate

- Federal corporate tax rate drops to 21% and corporate AMT is repealed.
- State Tax Impact
 - State income taxes will be a more significant portion of domestic tax liability.
 - State portion of deferred tax assets / liabilities derived from the “state tax rate, net of federal benefit” will be more significant.
 - State rates are staying static while state income taxable income increases.
 - A smaller federal tax liability means a greater taxable income in many states.
 - Repeal of federal corporate AMT is not necessarily a repeal of state corporate AMT.

State Conformity to the IRC

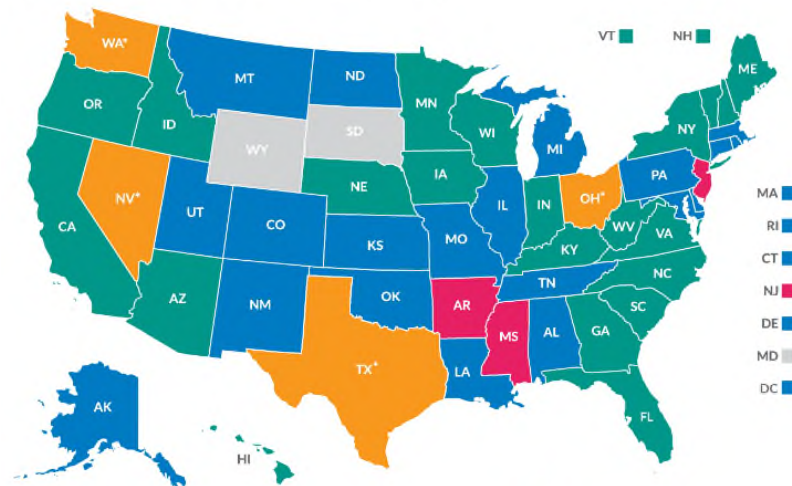
States generally conform to the IRC in one of two ways:

- 1. Static or Fixed-Date Conformity** states adopt the IRC as of a particular date.
 - These states will have to amend their laws to conform to the Act. Otherwise, taxpayers will have to prepare two federal returns under two different versions of the IRC.
- 2. Rolling Conformity** states automatically adopt the currently enacted version of the IRC.
 - These states will have to affirmatively decouple from any provisions in the Act that they do not want to adopt.

In both cases, the executives and legislatures of each state imposing an corporate net income tax will be forced to quickly make complex policy decisions around the burden they impose on their taxpayers.

Federal Conformity – Corporate Income Tax

Does Your State's Corporate Income Tax Code Conform With the Federal Tax Code?



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

- Rolling Conformity
- Static Conformity
- No Conformity (State Calculation)
- State Levies Gross Receipts Tax*
- No Corporate Income Tax

State Reporting Methods

State reporting methods can be put into three categories:

1. **Same as federal** states require state reporting on the same basis as is required for the federal return.
 - These states still likely de-couple from certain federal provisions, so state tax base will differ from federal tax base.
2. **Separate reporting** states require a separate tax return for each legal entity doing business in the state.
 - These states likely de-couple from the federal consolidated return regulations, producing additional layers of complexity in applying the provisions of the Act.
 - There is often confusion around the state calculation of limitations and deductions that are federally determined on a consolidated basis.
3. **Combined filing** states require the inclusion of some, but not necessarily all entities included on the federal return.
 - The provisions of the Act as applied to multiple unitary group filings, stacked returns, and water's edge filings could produce unexpected results.

Changes to Dividends Received Deduction

Ownership %	Deduction Under Prior Law	Deduction Under New Law	Provision
80% or more	100%	100%	§243 (Domestic)
20% - 80%	80%	65%	§243 (Domestic)
Less than 20%	70%	50%	§243 (Domestic)
10% or more Foreign	0%	100%	§245A (Foreign)

- State Tax Impact
 - States that do not decouple from IRC §243 would be impacted by the reduced DRD percentages
 - There may be constitutional infirmities where the domestic provisions differ from the foreign provisions.

Domestic DRD Hypotheticals

Rule	Ownership %	Dividend	DRD	Apportionment %	Tax rate	Tax
Federal Under Old Law	10%	10,000,000	7,000,000	N/A	35%	1,050,000
Federal Under New Law	10%	10,000,000	5,000,000	N/A	21%	1,050,000
Rolling Conformity – State Adopts Act	10%	10,000,000	5,000,000	50%	9%	225,000
Fixed Conformity – State Uses Prior IRC	10%	10,000,000	7,000,000	50%	9%	135,000
State Allows No Deduction	10%	10,000,000	0	50%	9%	450,000
State Allows Full Deduction	10%	10,000,000	10,000,000	50%	9%	0

Foreign Dividends and Deemed Repatriation of E&P

Type of Income	Under Prior Law	Under New Law
Foreign source dividends received from a 10% owned foreign corporation	Taxable at 35% rate when repatriated vs. deemed paid FTC.	100% DRD; not subject to federal tax.
Undistributed E&P	Taxable at 35% rate when repatriated.	Deemed repatriated as of 1/1/18, and taxable at a rate of 8% or 15.5%, depending on the type of income.

- State Impact:
 - Many states exclude Subpart F income; those that do not may still exclude the deemed repatriation income under the state's DRD.
 - This raises the Constitutional question of whether the state is treating foreign income differently than domestic income.

Foreign Dividends and Deemed Repatriation of E&P

- *Kraft General Foods, Inc. v. Iowa Dept. of Rev. & Finance*, 505 U.S. 71 (1992)
 - Kraft received dividends from foreign subs, and IA included them in Kraft's tax base. IA excluded similar dividends received from domestic subs. In both respects, IA law tracked federal law regarding these dividend deductions. Kraft objected to the inclusion of foreign dividends, arguing that it violated the Foreign Commerce Clause of the US Constitution.
 - SCOTUS sided with Kraft, finding that the IA statute discriminates against foreign commerce because IA "imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries." SCOTUS noted that "the constitutional protection against state taxation of foreign commerce is broader than the protection afforded to interstate commerce."
- *In the Matter of the Appeal of Morton Thiokol, Inc.*, 254 Kan 23 (1993)
 - Morton argued that KS's treatment of foreign dividends violates SCOTUS decision in *Kraft*.
 - KS Supreme Court disagreed, distinguishing IA and KS tax schemes and noting that, unlike IA, KS permits combined filing for unitary businesses. This was significant for KS because it gave the state an independent basis for taxing both foreign and domestic dividends, therefore balancing the burdens.

Interest Expense Limitation – IRC 163(j)

	Under Prior Law	Under New Law
Interest Expense, Generally	100% Deductible	Limited to the sum of interest income + 30% of adjusted taxable income + floor plan financing interest
Interest Expense for real estate businesses, farms and certain utilities	100% Deductible	100% Deductible
Interest Expense for companies with less than \$5 million in gross receipts	100% Deductible	100% Deductible

- Many states already disallow deduction of interest paid to affiliates—this goes further by limiting all interest and is likely to increase state income taxes for many taxpayers.
- Double taxation will occur when the borrower must addback interest expense and the lender must pay tax on the interest income.
- Will state carryforwards be unlimited like the federal carryforward?

Full Expensing of Certain Property – IRC 168

- Prior Tax Law
 - Recover investment over the investment's applicable life under MACRS or ADS
- New Tax Law
 - 100% full expensing for investments in new and used property made after 9/27/2017 and before 1/1/2023 under IRC 168(k)
- State Impact
 - Most states (about 30) do not conform to existing bonus depreciation regime
 - Financial impact of full expensing in states with rolling conforming may result in these states decoupling
 - Several issues arise in nonconformity states (e.g., federal / state basis discrepancies)

Full Expensing of Certain Property – IRC 168

Pennsylvania Decoupling Example

- Purchase \$1,000,000 Lease Fleet
- Full Year 1 Expensing for Business Property via 168(k) 100% Bonus Depreciation
- Pennsylvania Decouples & Adds Back all 168(k) Bonus Depreciation
- PA Corp. Tax Bulletin 2017-02 (Dec. 22, 2017) says no MACRS – Recovery in Year of Sale

	Federal 100% Expensing - 1st Year Cost Recovery	Pennsylvania Decouples - Last Year Cost Recovery
Year 1 - 168(k) Bonus Depreciation Deduction	\$ 1,000,000	\$ -
Year 2	\$ -	\$ -
Year 3	\$ -	\$ -
Year 4	\$ -	\$ -
Year 5	\$ -	\$ -
Year 6 - Sell Vehicles for \$100,000	Basis = 0 Taxable Gain = \$100,000	Basis = 1,000,000 Deductible Loss = (900,000)

Full Expensing of Certain Property – IRC 168

Pennsylvania Decoupling Example

- Results in increase in Pennsylvania tax base for years 1-5 because no deduction for depreciation;
- Potential Mitigation:
 - “Finance Receipts” should still be sourced outside of Pennsylvania – reduce Pennsylvania apportionment;
 - PA Corp. Tax Bulletin 2017-02 (Dec. 22, 2017) goes beyond statute by disallowing depreciation in years 1-5 - compute depreciation on bonus property for Pennsylvania purposes as if federal bonus depreciation had never been enacted (*e.g.* MACRS).

Like-Kind Exchanges Limited to Real Property

- Limitation of “Like-Kind” Rules
 - New Tax Law
 - Gains and losses of “like-kind” exchanges of non-real property no longer treated as nonrecognition items for Federal tax purposes
 - State Impact
 - Definition of “real property” v. “tangible personal property”
 - Does state or federal control?
 - Inconsistent accounting and reporting – traps / opportunities?

Like-Kind Exchanges Limited to Real Property

- California Conforms to the 1986 IRC which contains 1031 like kind provision;
- California Return Instructions:
 - ✓ Complete federal Form 8824, Like-Kind Exchanges, using California amounts when computing gain from like-kind exchanges;
 - ✓ Taxpayers who exchange property located in California for like-kind property located outside of California under Section 1031 information return FTB 3840;
- Tax Reform Eliminates Federal Like-Kind exchanges of Tangible Personal Property—California does not;
- Taxpayers should analyze the impact and discuss positions.

Other Tax Considerations – NOLs

	Prior Law	New Law
NOL Carryforward – Taxable Income Limitation	None	80%
NOL Carryforward – Time Limitation	20 years	None

- State Impact

- Deferred tax assets related to NOL carryforwards and adjustment of valuation allowances—increase or decrease valuation allowances?
- Impact of acquisitions of historical NOL companies— IRC § 382 loss limitation calculation doesn't translate easily to post-apportionment states.
- Add the Federal 80% limitation to post-apportionment state NOL deduction and carryforward calculations become even more complicated

Other Tax Considerations – Exempt Organizations

- New Tax Law
 - Requires UBTI to be computed separately for each trade or business and increases UBTI by amount of certain fringe benefit expenses for which deductions are disallowed
- State Impact
 - States that have rolling conformity must decide whether to conform to Federal UBTI changes which could increase state taxes on exempt organizations

STATE TAX IMPLICATIONS OF INDIVIDUAL TAX REFORM

Individual Tax Changes

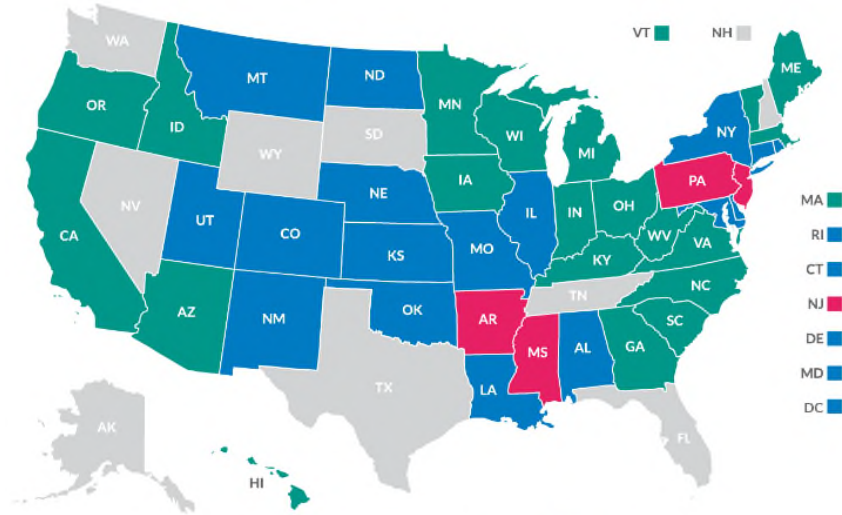
- Tax Considerations – General
- State Conformity to the IRC
- State and Local Tax Deduction
- Other Tax Considerations

Tax Considerations – General

- New Tax Law
 - SALT deduction limited to \$10,000
 - Standard deduction married \$24,000 (from \$13,000), and single \$12,000 (from \$6,500)
 - Suspension of miscellaneous itemized deduction and casualty losses
 - Raise AMT exemption threshold
 - Estate tax exclusion of \$11.2M single / \$22.4M married (until 2026)
- State Tax Impact
 - Various state tax issues relating to conformity
 - SALT deduction limitation may pressure high tax rate states to lower tax rates
 - States that impose estate taxes may have even more pressure to raise exclusion thresholds

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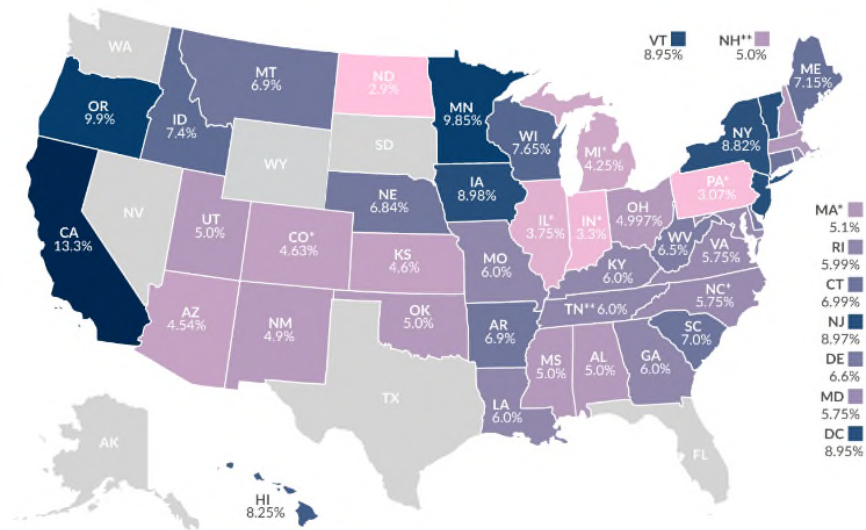
SALT Deduction

- New Tax Law
 - For tax years beginning after 12/31/2017, the SALT deduction is capped at a total of \$10,000 (\$5,000, married filing separately) in income, property, and other previously uncapped taxes
 - Specifically bars taxpayers from prepaying 2018 state & local *income* taxes, but it did not limit the prepayment of real property taxes
- State Tax Impact
 - Individual taxpayers pre-pay 2018 *property* taxes and take a full, uncapped deduction for those payments on their 2017 returns
 - Limited impact for AMT filers
 - High tax states pressure to lower taxes?
 - Population shift to states with lower taxes?

Individual Tax Rates

How High Are Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates, 2016



Note: (*) State has a flat income tax. (**) State also only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. It is not an effective marginal tax rate, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included. Source: State tax forms and instructions.



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SALT Deduction: State Reactions

- Lowey–King bipartisan Federal bill
 - Lowey (D-NY) / King (R-NY) propose full repeal of SALT deduction
- Charitable Contributions in Lieu of State Income Tax
 - CA S.B. 227 – allow taxpayers to make a donation to the “California Excellence Fund” instead of paying the California income tax and receive fully deductible credit
- Replacing Income Tax with Employment Taxes
 - Fully deductible payroll taxes imposed directly on employers

SALT Deduction: State Reactions (cont'd)

- NY Hold Harmless Proposals
 - S.B. S6974 – limits impact of Federal tax reform on residents' state tax by amending tax law to calculate state income tax based on IRC in effect prior to tax reform and
 - S.B. S6951 – establishes a tax credit equal to any increase in federal tax liability
- Constitutional Challenges
 - Due Process
 - Equal Protection

Other Tax Considerations – State Employment Tax

- States to adjust withholding schedules?
 - Many states use Federal personal exemptions for state withholding allowances
- More scrutiny on traveling employees?
 - Pressure on high tax states to tax nonresident employees working in state
 - More states to adopt “Convenience of Employer” type rules?
 - Congress to revisit Federal Mobile Workforce Legislation?
- Employee relocation from high tax states to low tax states
 - Travel expense and business expense reimbursement issues



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QUESTIONS?

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Biography



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Don Abrams' practice primarily focuses on advising corporations, partnerships, and individuals on federal, state, and international tax controversy and transactional tax planning matters. His transactional practice includes advising clients on structuring and negotiation of mergers and acquisitions; equity and debt financing transactions; and transactions involving the structuring, formation and operation of specialized investment entities (including domestic and foreign hedge funds, regulated investment companies and real estate investment trusts). Don's controversy practice includes representation of clients in federal and Massachusetts administrative and court proceedings.

Biography



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With a focus on state and local tax issues involving corporations, partnerships, and individuals, Cosimo A. Zavaglia advises clients on a range of multistate tax issues, including controversy, planning, and compliance. Cosimo handles matters related to state and local income and franchise taxes, gross receipts taxes, entity-level taxes, sales and use taxes, telecommunications taxes, and real estate transfer taxes. He also develops state tax planning strategies for corporate restructurings, mergers, acquisitions, and dispositions.

Biography



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Daniel M. Dixon focuses his practice on providing the highest quality State and Local Tax (SALT) counsel and advocacy to Fortune 500 companies and beyond. Often this counsel and advocacy results in saving corporations significant state taxes. He has resolved both through litigation and settlement, difficult state tax matters before administrative appeal boards, tax tribunals, and courts in more than 25 states.

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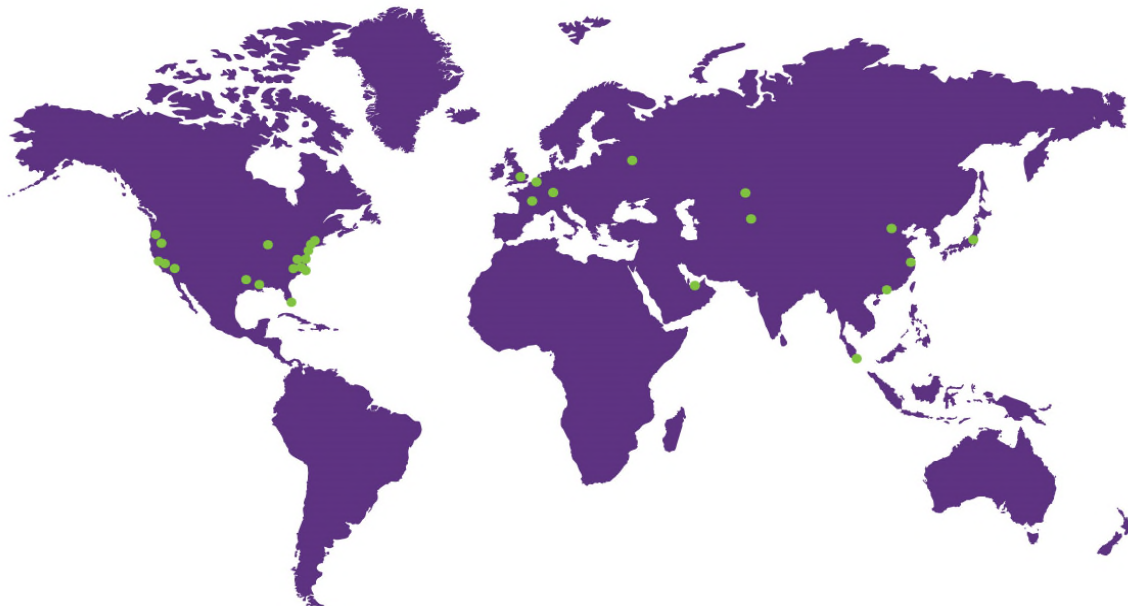
Justin D. Cupples focuses his practice on providing the highest quality State and Local Tax counsel and advocacy to Fortune 500 companies and large multistate organizations. Justin obtains significant state tax savings for his clients by developing and implementing state tax return positions, defending state tax audits, and advocacy through administrative appeals and litigation.

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