Update on State Tax Conformity with Federal Tax Reform

NESTOA Annual Meeting
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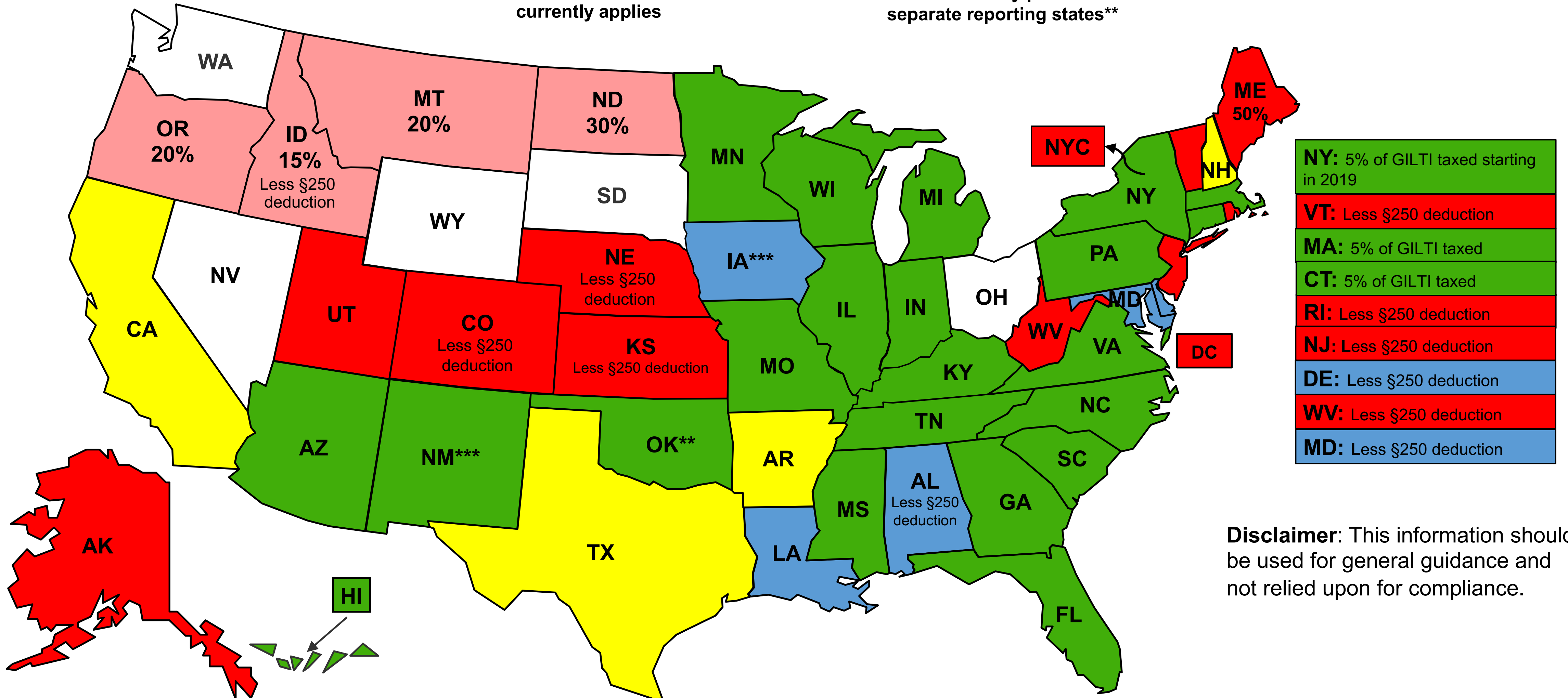
Agenda

- **Key International Tax Provisions Impacting the States**
- **Factor Representation and Constitutional Issues Relating to State Taxation of Foreign Source Income**
- **Key Domestic Tax Provisions Impacting the States**

Key International Tax Provisions Impacting the States

State Corporate Income Tax Conformity to GILTI*

- State does not impose a corporate income tax
- Decoupled from GILTI (or excludes 95%)
- Have not addressed IRC conformity and/or GILTI coupling specifically. Neither GILTI nor § 250 deduction currently applies
- Potentially coupled to GILTI, but inclusion may be constitutionally prohibited in separate reporting states**
- Coupled or potentially coupled to 10% to 30% of GILTI**
- Coupled or potentially coupled to GILTI**



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Note: Those states with "less §250 deduction" only tax 50% of GILTI (or 62.5% after 2025).

* Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or state personal income tax (PIT) purposes.

** GILTI is not specifically referenced in many state conformity statutes so some states may still decouple from some or all of GILTI by administrative/legislative action.

*** Iowa conformity begins in 2019. New Mexico decouples starting in 2020.

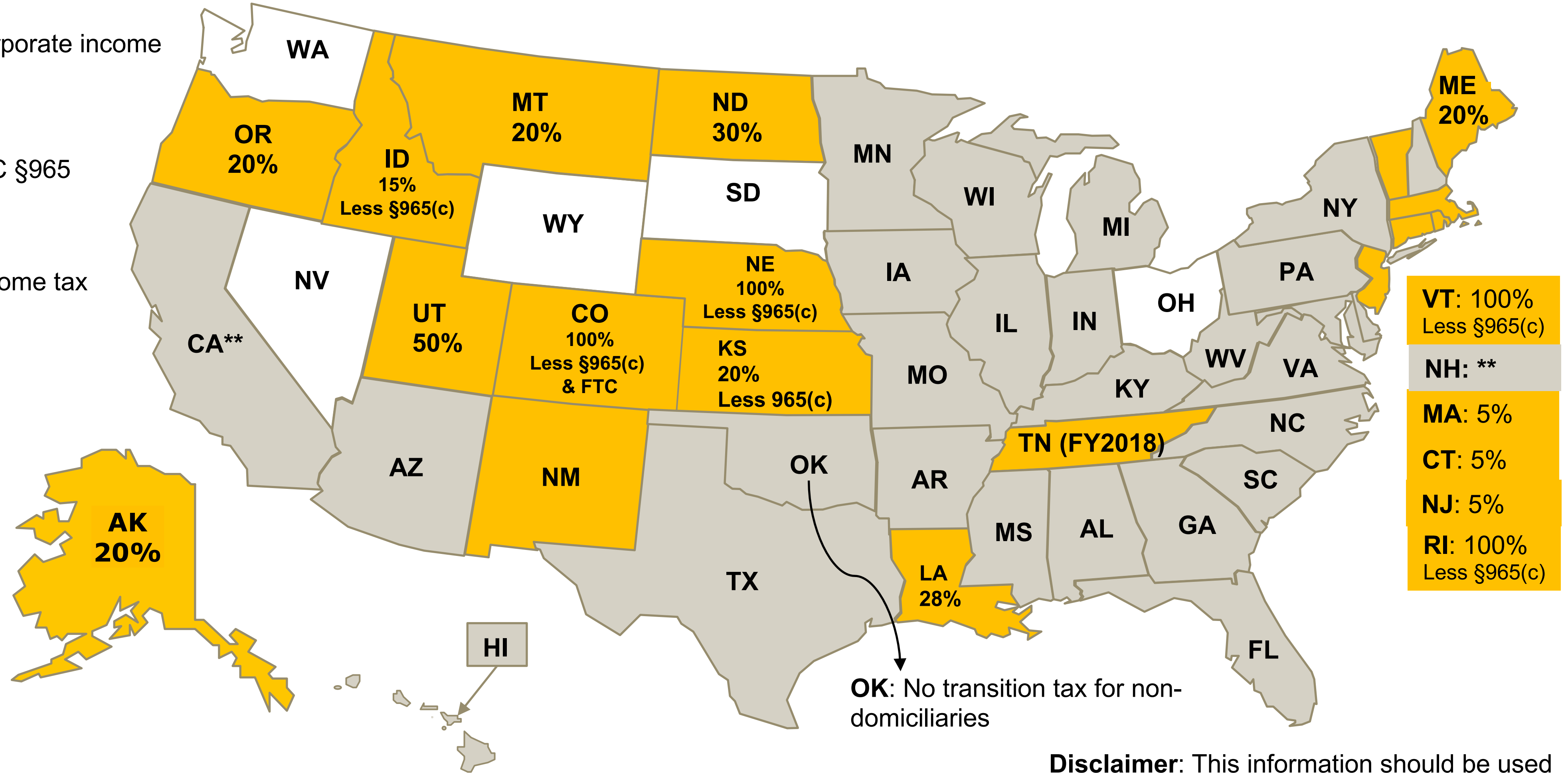
Source: Council On State Taxation

One Time Issue: State Corporate Income Tax Conformity to IRC §965 Repatriated Income*

State does not impose a corporate income tax

0%: State does not impose corporate income tax on IRC §965 repatriated income

State imposes corporate income tax on some or all of IRC §965 repatriated income



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**No conformity update but taxes a portion of foreign dividends (when distributed) for water's edge filers.

Source: Council On State Taxation

Foreign Derived Intangible Income (FDII): IRC §250

- **General Overview**: Provides a 37.5% deduction (decreased to 21.875% after 2025) for certain income earned by a U.S. domestic corporation attributed to foreign sales relating to U.S. production.
  - FDII is calculated in a manner similar to GILTI. Returns in excess of 10% of fixed assets form the basis for the calculation.
- **State Tax Issues**:
  - Modest State Conformity – approximately one dozen states have conformed to FDII.
    - Selective decoupling – FDII, as enacted, is designed to work with GILTI.
  - The impact of FDII will be affected by a taxpayer's state income tax filing method.
  - Apportionment: Is any special apportionment formula needed?

Factor Representation and Constitutional Issues Relating to State Taxation of Foreign Source Income

Factor Representation: GILTI and IRC §965 Repatriated Income

- The apportionment methodologies available to the states include:
  - No factor representation.
  - No specific guidance which can result in a taxpayer using its “domestic” factors to apportion GILTI/965 income or including its net GILTI/965 income in the denominator.
  - Net GILTI/ Section 965 income in the denominator.
  - Gross Receipts that produced the GILTI/ Section 965 income in the denominator.

Factor Representation: GILTI and IRC §965 Repatriated Income

- To date, the vast majority of the states provide no guidance on how to apportion GILTI/ Section 965 income or allow only the **net taxable foreign source income**, and not the gross receipts (or other factors) to be included in the denominators of the respective factors.
- New Jersey apportionment method for GILTI:
  - Initial apportionment methodology: NJ GDP over total GDP of all the U.S. states in which the company has economic nexus (TB-85(R))
  - Revised apportionment methodology: Net GILTI in the denominator of the receipts factor (TB-92).

GILTI State Factor Representation*

State does not impose a corporate income tax

The state currently does not impose its corporate income tax on GILTI

No factor representation allowed

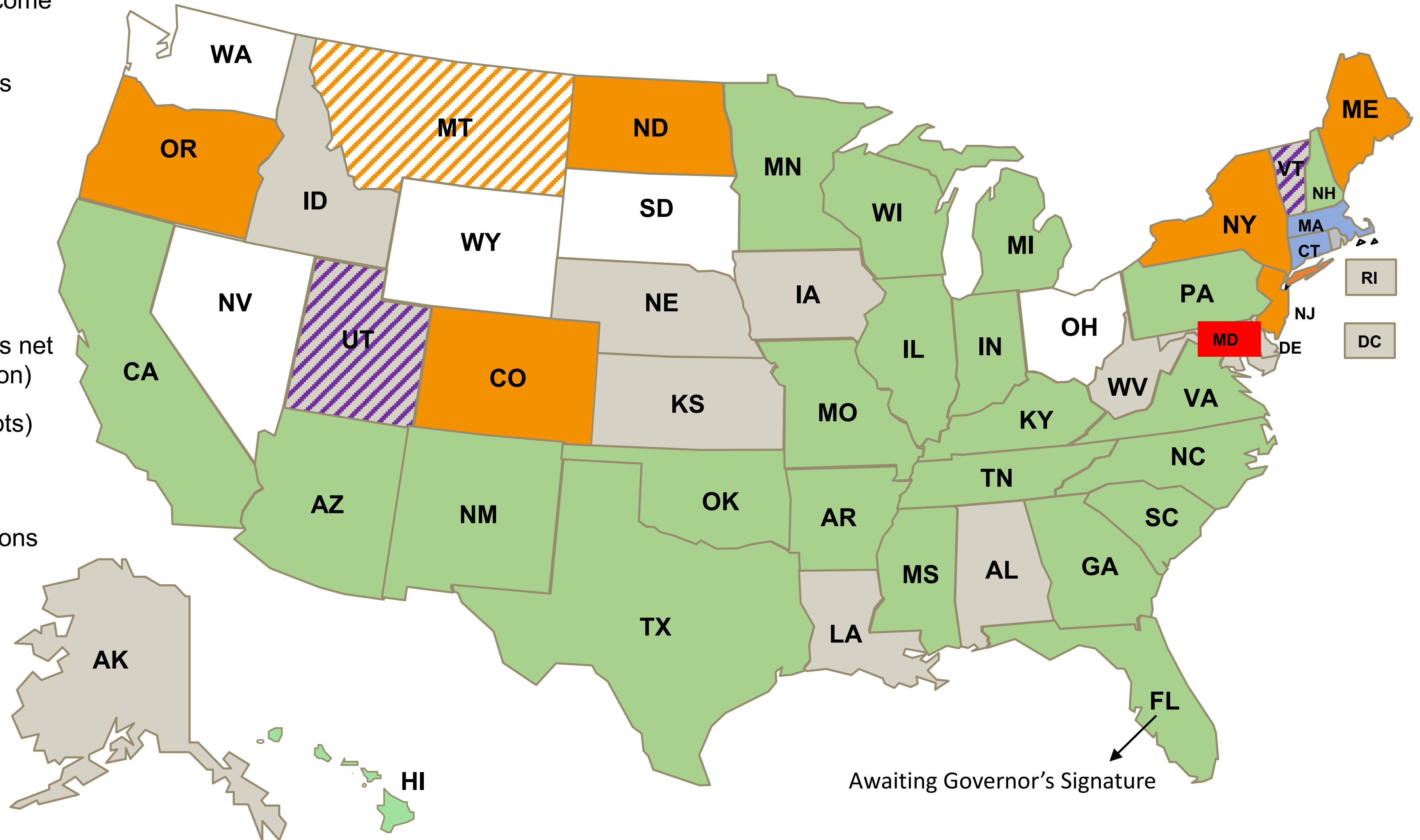
No new guidance

Other methodology

Sales factor denominator only includes net GILTI (after Sec. 250 or other deduction)

Foreign factors (including gross receipts) relating to taxable income allowed in denominator(s)

Pattern indicates unofficial state positions (in appropriate colors)



* Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or PIT purposes.

Source: Council On State Taxation

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Future Litigation over State Taxation of GILTI and IRC §965 Repatriated income

– **Separate reporting states: Can the foreign source income be taxed at all?**

- See *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992). A separate reporting state may not tax dividends from a controlled foreign corporation if it does not tax dividends from a controlled domestic corporation.

- Five separate reporting states (plus NJ in 2018) are still coupled to GILTI

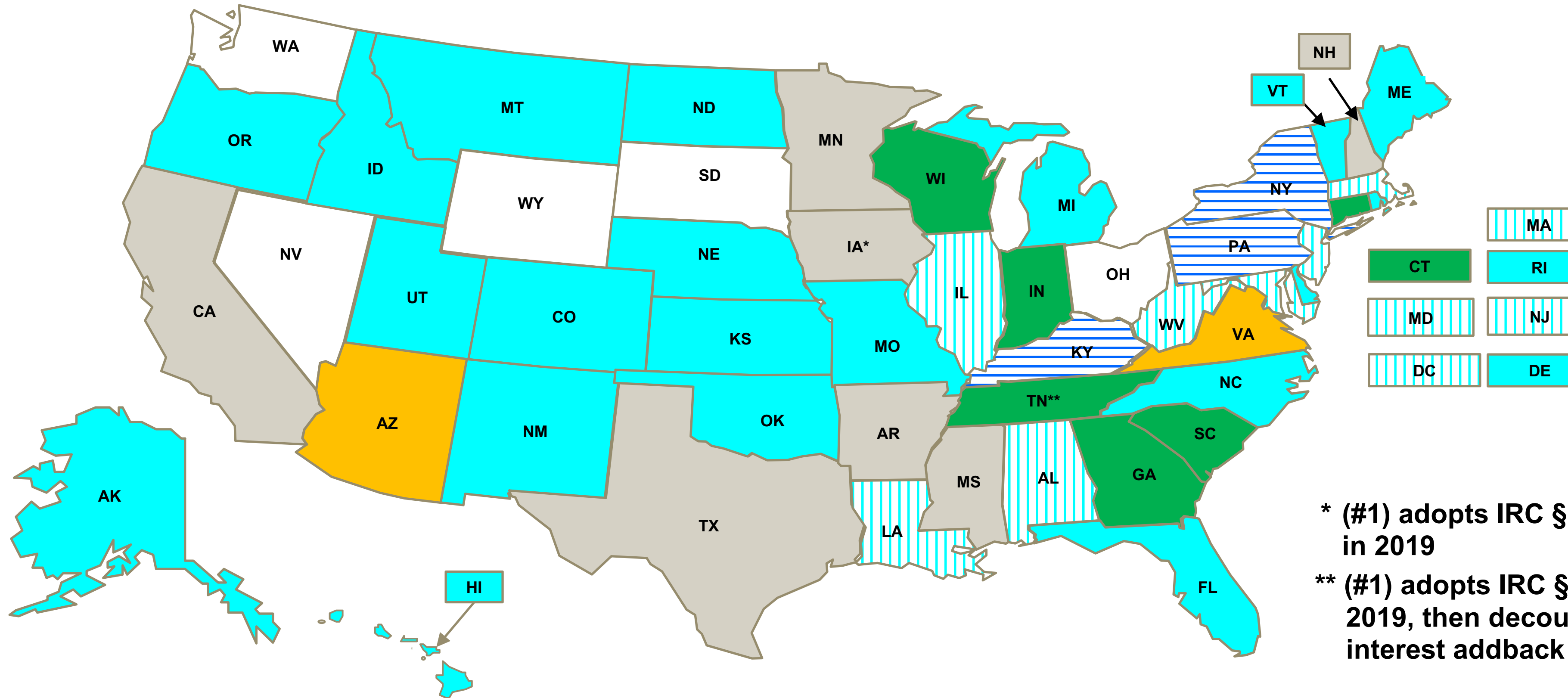
Future Litigation over State Taxation of GILTI and IRC §965 Repatriated income

– **Combined reporting states: Can the foreign source income be taxed without appropriate factor representation (or a unitary relationship)?**

- Does the state taxation of GILTI (and IRC §965 Repatriated income) in combined reporting states violate Commerce Clause limitations unless appropriate foreign "factor representation" is allowed.
- This is not a new issue – the same issue arose in connection with how states apportion income from foreign dividends.
  - *See E.I. du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Maine 1996); and *Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993).

Key Domestic Tax Provisions Impacting the States

State Conformity to 30% Interest Expense Limitation



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*** (#1) adopts IRC §163(j) in 2019**

**** (#1) adopts IRC §163(j) in 2018 and 2019, then decouples. State has interest addback**

5	**No General Corporate Income Tax**
20	**Adopts IRC §163(j) as of 1/1/18**
3	**Adopts IRC §163(j) with interest addback related to intangible income**
8	**Adopts IRC §163(j) and has general interest addback provisions**
6	**Enacted Legislation Decoupling from IRC §163(j) [Note – some of these states did not decouple as of 1/1/2018 but decoupled at a later date and some states may still have an intercompany interest expense adjustment]**
2	**For 2018 tax year – IRC adopted as of 1/1/2017 effectively decoupling from IRC §163(j)**
7	**Does not adopt IRC § 163(j) as of 1/1/18**

Source: Council On State Taxation

Other State Tax Issues Related to the TCJA

- **100 Percent Expensing**
  - The TCJA allows 100 percent expensing for most capital investments for 5 years; however, most states decouple from this provision just as the states decoupled from bonus depreciation.
- **Net Operating Loss Limitations and Carryforwards**
  - Numerous differences between Federal and State rules continue
- **State Conformity with the Deduction for Pass Through Entities**
  - Impact limited to a minority of states with PIT tied to federal “taxable income”
- **Limitation of SALT deduction for state taxes paid to $10,000**