



Legal Alert: The State and Local Tax Implications of Federal Tax Reform

November 10, 2017

On November 2, 2017, Republicans in the House of Representatives released their much-anticipated tax reform bill (the House Plan). The Tax Cuts and Jobs Act (H.R. 1) proposes numerous changes to the Internal Revenue Code, many of which will have an impact on taxpayers' state and local tax liabilities. For additional information on the House Plan generally, please see [our previous alert](#).

Conformity and a changing federal tax base

The cornerstone of the House Plan is a significant reduction in the corporate income tax rate. In addition to the rate cut, the House Republicans propose changes to the federal income tax base by either contracting or expanding the base. Most states conform to the federal income tax base—at least in part. Consequently, federal base changes—either in the form of contraction or expansion—will have an impact on the state tax bases. Whether states will follow the federal treatment or decouple from any or all of these new provisions remains to be seen.

States will need to weigh many considerations as they decide whether to conform. For example, states are generally required to balance their budgets, and many of the changes may simply be too expensive for a state to adopt. Many states also have constitutional restrictions on the ability to increase taxes. A state may require a super majority or a vote of the citizens in order to adopt some of the proposed federal changes to the extent they increase state taxes. An overriding issue for many states will be to what extent do they want to deviate from a federal base. Deviation complicates compliance and raises tough policy questions on why a state would tax income differently than the federal government—particularly when it comes to some of the personal income tax provisions.

The House Plan proposes the following significant base-changing provisions, as well as other minor changes:

- ***Increased expensing – Tax base contraction***

- The House Plan allows for the immediate expensing of 100% of the cost of qualifying property (generally property other than real property) acquired and placed in service after September 27, 2017, and before January 1, 2023 (with an additional year for certain qualified property with a longer production period).
- Many states have already decoupled from bonus depreciation and some accelerated depreciation provisions due to the financial impact on the states' tax revenues. States must decide whether to conform to this

Related People/Contributors

- Michele Borens
- Jonathan A. Feldman
- Jeffrey A. Friedman
- Todd A. Lard
- Carley A. Roberts
- Marc A. Simonetti
- Maria M. Todorova
- Eric S. Tresh
- Scott Wright
- Douglas Mo
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- Michael J. Kerman
- Nicholas J. Kump
- Huy "Mike" N. Le
- Chelsea E. Marmor
- Robert P. Merten III
- DeAndre R. Morrow
- Suzanne M. Palms
- Hanish S. Patel
- Alla Raykin

increased expensing provision. Given that states already largely decouple from the federal depreciation rules, it should be expected that a large number of the states will also decouple from this provision.

• Debra L. Salvato

• ***Limitations on interest expense deduction – Tax base expansion***

- The House Plan disallows a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. Any disallowed interest expense deduction could be carried forward for five years.
- The House Plan limits the deductible net interest expense of a domestic corporation that is part of a multinational group to the extent the domestic corporation's share of the group's global net interest expense exceeds 110% of the domestic corporation's share of the group's global earnings before interest, taxes, depreciation and amortization.
- States generally conform to the federal tax rules for the deductibility of interest, so conformity to the proposed federal changes will increase state tax bases. However, many states have special addback rules that already limit the deductibility of interest paid to related parties. A few states also routinely challenge the deductibility of interest by applying their own multi-factor test to distinguish between debt and equity in a manner that differs from the federal treatment. Moreover, while the federal government has great latitude in how it taxes multinational groups, the Commerce Clause restricts a state's ability to apply special rules to multinational groups that do not apply to purely domestic groups. A state will have to consider the interaction of all of these issues as it decides whether to conform.

• ***Revisions to net operating loss deduction***

- The House Plan disallows net operating loss (NOL) carrybacks, but provides that NOLs could be carried forward indefinitely. Further, the NOL deduction in a given year would be limited to 90% of the taxpayer's taxable income.
- States currently vary widely in how they conform to the federal NOL rules. Most states, but not all, do not allow for a NOL carryback. While most states allow NOLs to be carried forward for 20 years, many states have shorter carryforward periods. Many states also already modify the computation of the federal NOL so the state NOL differs from the federal NOL. Further complicating the application of NOLs, most states have clear rules on whether NOLs have to be applied on a postapportionment or preapportionment basis, and whether a state recognizes federal limitations on NOLs found in IRC § 381 and § 382. Although many states have already deviated from the federal carryforward and carryback periods, other states will have to determine if they want to

deviate from the new periods and address the necessary complications that arise from having state NOLs tracked separately from federal NOLs. The 90% cap presents a unique issue for all states that will require careful consideration of how the 10% of income that is taxed flows to the state returns. For states that conform to these changes, these limitations will flow through and impact the state tax base.

- ***Contributions to capital***

- The House Plan includes in a taxpayer's taxable income any contributions to capital that the taxpayer receives, to the extent that the value of the contribution exceeds the fair market value of any stock that is issued in exchange for the contribution.
- The Ways and Means Committee Majority Tax Staff summary specifically mentions that this change applies to incentives that state and local governments offer to businesses that locate operations in their jurisdiction. By increasing taxable income at the federal level and possibly at the state level, this provision could decrease the total value of these types of state tax incentives.

- ***Like-kind exchanges***

- The House Plan disallows deferral of recognition of gain from a like-kind exchange for personal property.
- This provision will have a significant impact on industries that rely heavily on equipment and capital, such as manufacturing or telecommunications companies. Currently, most states conform to the federal treatment of like-kind exchanges, although some states require that the replacement property be located in the state. For states that conform to this new provision, this tax base increase will flow through and impact the state tax base.

State and local taxation of foreign source income

The House Plan proposes numerous changes that would move toward a territorial system of taxation. These proposed changes will have an impact on state and local taxation, both by changing a taxpayer's federal taxable income and by impacting taxpayer decision-making:

- ***Establishment of a participation exemption system and revisions to foreign tax credits***

- The House Plan allows for a 100% dividends received deduction (DRD) for dividends paid out of foreign source income from a foreign corporation to a US shareholder that owns 10% or more of the foreign corporation and disallows any credit or deduction for foreign taxes

related to any exempt dividend.

- The House Plan also imposes a reduced-rate one-time transition tax on previously untaxed foreign earnings and profits (E&P) if the US shareholder owns 10% or more of the foreign subsidiary, by increasing the subpart F income of that shareholder and allowing a dividends received deduction equivalent at the US level to bring the effective rate of US tax down to between 5% and 12% (depending on the cash assets of the group).
- As a reaction to the decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), most states already allow a dividends received deduction for dividends received from a foreign subsidiary to the extent that they allow a similar deduction for a dividend from a domestic subsidiary. With respect to the transition tax, states currently generally include subpart F income in the state tax base, so an increase in subpart F income should flow through to the tax base in most states. However, the technical operation of the transition tax may complicate state conformity. The technical mechanism for the reduced rate on the transition rule is to include the income under subpart F at a 35% rate and to provide a dividends received deduction-equivalent deduction at the US level to bring the effective federal tax rate down to between 5% and 12% (depending on the cash assets of the group). Given that these two rules work in tandem, states may struggle to apply both components while navigating the restrictions of Kraft.

- ***Modifications to Subpart F***

- The House Plan makes permanent the section 954(c)(6) look-through provision that provides that dividends, interest and royalties received by one foreign subsidiary of a US parent from a related foreign subsidiary generally are not includible in the income of the US parent.
- It also creates a new provision similar to subpart F income which imposes a worldwide minimum tax on the earnings of controlled foreign corporations.
- Because the look-through provision already exists, making it permanent should not change anything significantly for states. It is unclear how the worldwide minimum tax on foreign earnings will be included on a federal tax return, but to the extent that it is treated similarly to subpart F income, many states will likely conform, because many states currently include subpart F income in state taxable income.

- ***Prevention of base erosion***

- The House Plan imposes a 20% excise tax on the gross amount of

payments (other than interest) from a US corporation to a related foreign corporation, unless the foreign corporation elects to treat the income as effectively connected to a US trade or business and therefore taxable by the United States.

- A federal excise tax would fall outside of the realm of state income tax conformity. However, if the foreign corporation elects to treat the income as effectively connected, it will subject itself to US federal income tax. Businesses should consider the state tax implications before making this election. By electing to pay income tax rather than the excise tax, a taxpayer will waive treaty protections and the income that the foreign corporation receives will be subject to US federal income tax. The effect of this on the taxpayer's apportionment factor will likely vary by state and may need to be addressed by additional state legislation. Further, this might change the US parent corporation taxpayer's addbacks, because states generally allow an exception from related party addback rules if the recipient of the payment is subject to US tax.

See the Eversheds Sutherland [Tax Reform Law blog](#) for more information, including the text of the House Plan, the House Ways and Means Committee Summary, and the Joint Committee on Taxation Explanation, as well as additional in-depth analysis of the provisions discussed below, including our separate alerts on the [employee benefits and compensation](#), [energy](#), [insurance](#) and [accounting methods](#) provisions and our anticipated alert on the US international provisions of the House Plan.

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