Domestic & Multistate Update – TCJA and Other 2018 Developments

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John Paek, Baker & McKenzie LLP

Brian Rose, Deloitte Tax LLP

Agenda

- Overview of State Tax Conformity with the Tax Cuts and Jobs Act
- Key International Tax Provisions Impacting Federal & State Taxes
- Key Domestic Corporate Tax Issues & Impact to States
- *Wayfair* and State Responses

Overview of State Tax Conformity with the Tax Cuts and Jobs Act

Key Tax Law Changes in the TCJA and Differences from the Tax Reform Act of 1986

- **Revenue Neutral vs. Deficit Financed**
  - The Tax Reform Act of 1986 provided for about $120 billion of PIT cuts financed by about $120 billion of CIT increases.
  - The Tax Cuts and Jobs Act (P.L. 115-97) (TCJA) provides for $6 trillion over 10 years of tax cuts and only $4.5 trillion over 10 years of tax increases.
- **Transformational Changes**
  - 40 percent corporate tax rate cut to sync up with OECD norms.
  - Lower PIT rate – and pass-through deduction for individuals.
  - Broad new limitations on the interest deductions.
  - Bonus depreciation and immediate expensing.
  - $10k limitation on state and local tax deductions for individuals.
- **International Tax Reform**
  - Moves the U.S. from a worldwide to a quasi-territorial tax system consistent with U.S. trading partners.
  - New foreign source tax provisions intended to raise revenues (to offset tax cuts) and tilt the playing field to favor domestic commerce over foreign commerce (e.g. GILTI; BEAT, FDII).

State Partial Conformity with the TCJA

– **Impact of the TCJA on Corporations:**
  - A federal tax cut of about 10%.
  - A state tax increase of about 12%.
    - COST/ EY study "The Impact of Federal Tax Reform on State Corporate Income Taxes" (based on 2018 update and pre-federal tax reform (FTR) linkage to IRC).

– This outcome is **inadvertent and arbitrary**: If states simply conform to the TCJA, either automatically or by updating the conformity date, and do nothing more they will link to federal corporate base-broadening measures, but not to federal tax rate reduction.

Top Increases and Decreases in Federal Corporate Tax Base with TCJA and Potential State Conformity

Business Tax Provision	% Change in Federal Corporate Tax Base	State Conformity
One-time transition tax on unrepatriated foreign earnings	+ 9 %	Partial conformity (but typically of 25% or less)
Net interest expense limitation (30% of ATI)	+ 6.4%	Mostly conformity
Global intangible low-taxed income (GILTI)	+ 5.5 % (gross)	Mixed conformity
Modification of net operating loss deduction	+ 5.3%	States have own provisions
Base Erosion and Anti-Abuse Tax (BEAT)	+ 4.0%	Non-conformity
Amortization of research and experimental expenditures	+ 2.9%	Conformity
Repeal of domestic production activities deduction	+ 1.9%	Partial conformity
Foreign derived intangible income (FDII) deduction	- 1.7%	Mixed conformity
Expensing provided under Section 168(k) bonus depreciation	- 1.8%	Limited conformity
Global intangible low-taxed income (GILTI) deduction	- 2.6%	Mixed conformity (but §250 issue)
100% foreign DRD	- 5.9%	States have own provisions

Key International Tax Provisions Impacting Federal & State

Global Intangible Low-Taxed Income (GILTI)

- **GILTI is a new annual federal calculation intended to ensure a minimum tax is paid on worldwide income and is effective in 2018.**
- **Three components are used in the federal GILTI calculation:**
  - **IRC §951A:** Includes all global income earned by the taxpayer's foreign subsidiaries. Makes assumption on how much is intangible based on a set rate of return on tangible assets.
  - **IRC §250(a)(1)(B)):** Provides an offsetting deduction to lower the effective tax rate.
  - **Foreign Tax Credits**: Finally, a credit is provided for 80% of taxes paid to foreign jurisdictions on the GILTI income, which ensures only low-taxed foreign income is subject to federal taxation. Generally, a taxpayer will not be subject to residual U.S. tax if the average foreign tax rate imposed on such income is at least 13.125%.

Is the Impact of GILTI different for State Tax Purposes than for Federal Tax Purposes?

- **Global:** Yes, it includes all of the global income earned by the taxpayer's foreign subsidiaries from conducting active trade or business
- **Intangible:** No, it includes significant income from services, digital products, intangible property, and a portion of tangible property sales
- **Low-Taxed:** No, the states do not conform to the (80%) foreign tax credit allowed for federal tax purposes to offset the GILTI income. In addition, many of the states may not conform to IRC Section 250 that allows for a 50% deduction for GILTI income.
- **Offset by Corporate Tax Cuts**: No, states do not conform to federal corporate tax cuts (Congress is raising $324 billion over 10 years from the international tax provisions to help pay for $654 billion in business tax cuts).

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GILTI: SALT Implications

- **Factor Representation relating to the inclusion of GILTI income:**
  - Will factor representation be allowed?
  - If so, will the sales factor be based on GILTI "net" income, gross foreign receipts, gross foreign receipts allocated by GILTI income, or some other formula?
- **State income tax conformity with GILTI (and other FTR provisions) may result in a number of constitutional challenges:**
  - Is the controlled foreign corporation (CFC) unitary with the U.S. filer?
  - Discrimination against foreign commerce in favor of domestic commerce (e.g. the *Kraft* precedent)?
    - Differences between separate reporting and combined reporting states
  - Is the inclusion of foreign income without corresponding factor representation unconstitutionally discriminatory?

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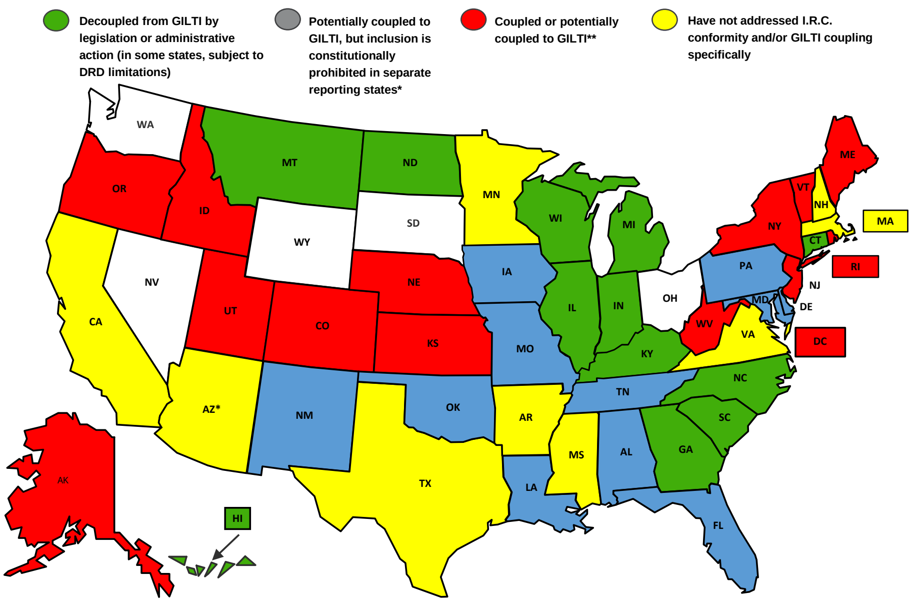
Chart 2
Current Status of State Conformity to GILTI



* See Part III.D for discussion of the taxation of GILTI in separate company states.

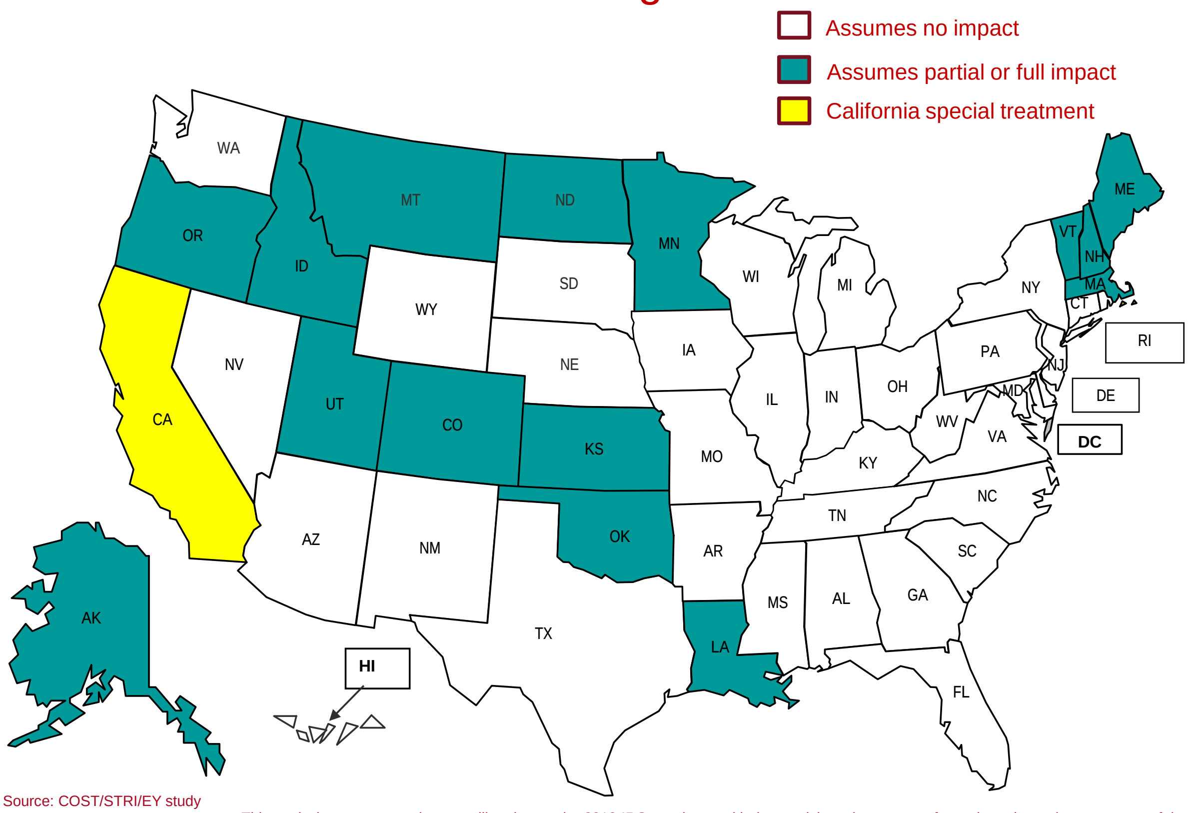
** Generally, GILTI is not specifically referenced in state conformity statutes so there remains the possibility that some of these states will decouple from some or all of GILTI by administrative guidance (*e.g.*, Kentucky, Connecticut) or future clarifying legislation.

IRC §965(a) Mandatory One Time Deemed Repatriation (Transition Tax)

– **IRC §965(a) provides for a one-time mandatory deemed repatriation of 30 years of accumulated foreign earnings.**
  - The IRC §965(a) provisions are effective in 2017.
    - IRC §965(c) reduces the federal tax rate on repatriated earnings to 15.5% for earnings of cash and cash equivalents and 8% for all other earnings.
  - The transition tax is reported on a new federal form created specifically for the one-time deemed repatriation, and is not reported as part of the regular federal taxable income.
  - The transition tax can be paid in installments over eight years.

– **About one-third of the states currently conform (in part) to the transition tax based primarily on prior treatment of foreign dividends or Subpart F income.**

Potential State Taxation of Accumulated Foreign Earnings



Source: COST/STRI/EY study

This analysis assumes each state will update to the 2018 IRC consistent with the provisions the state conformed to prior to the enactment of the TCJA. This map is intended for general information purposes only and should not be relied upon for tax advice.

Transition Tax State Issues

- **Will states adopt the 965 (c) tax rate reduction?**
- **Apportionment and factor representation issues.**
  - As the "deemed" dividends represent 30 years of earnings, what would adequately provide factor representation?
  - Over the 30 years encompassed in the mandatory "deemed" dividends period, a U.S. corporation's footprint in any given state may have changed significantly, and the state's method of apportionment (3FF, SSF) and tax rate may have changed significantly.
- **Earnings and profits are netted at the federal consolidated group level. This presents unique issues in separate entity states and states where the filing group differs from federal.**
  - Should the federal net earnings and profits be allocated among the group members?
  - Should taxpayers prepare separate E&P calculations based on the state filer, which could result in state specific "deemed" dividends?
- **If all mandatory repatriated income is excluded, will the state disallow expenses associated with the income?**

Key Domestic Tax Provisions & Impact to States

100% Bonus Depreciation – IRC §168(k)

- **General Overview:** Current bonus depreciation under IRC §168(k) is increased from 50% to 100% for property acquired and placed in service after 9/27/17 and before 12/31/22. The 100% expensing is phased down by 20 percentage points per calendar year beginning in 2023.
- **Key Provisions:**
  - Property subject to WBC considered "acquired" pre 9/27/17
  - Qualified property generally the same
  - Used property now generally qualifies
  - Newly released proposed Treasury Regulations
  - Qualified Improvement property - update

100% Bonus Depreciation – IRC §168(k)

- **<u>168k State Tax Issues</u>:**
  - Will states conform?
  - States that historically decoupled from bonus, will likely decouple from the increase to 100%
  - Straight coupling to federal vs. MACRS vs. different approaches
  - Tracking different methods in different states

IRC § 451(b) – Revenue Recognition

- **<u>General Overview</u>:** TCJA revises "all events" test to provide right to receive income generally met at earlier of current test OR when income is recognized for GAAP.

- **<u>Key Provisions</u>:**
  - Impacts unbilled receivables (e.g. licenses, services)
  - Likely exacerbated by adopting ASC 606/IFRS 15
  - Exception for special methods of accounting
  - Regulations and updated procedural guidance pending

IRC § 451(c) – Revenue Recognition

- **General Overview:** TCJA codifies Revenue Procedure 2004-34 which provides deferral opportunities for advance payments.
- **Key Provisions**:
  - Gross income recognized in year of receipt if recognized for GAAP purposes
  - Otherwise recognize in succeeding tax year
  - Effectively repeals Treas. Reg. 1.451-5
  - Notice 2018-35
    - Taxpayers may rely on RP 2004-34 until further guidance is issued
    - Includes a waiver on five year rule

Interest Expense Limitation – IRC § 163(j)

- **General Overview**: Business interest expense cannot exceed 30% of FTI exclusive of business interest income, business interest expense, depreciation, amortization.
- **Key Provisions**:
  - Limits the interest deductibility to 30% of tax EBITDA for tax years beginning prior to 1/1/22 and then 30% of EBIT
  - Limitation generally applies at the taxpayer level (e.g. consolidated tax return level); special rules apply to partnerships
  - Certain real property related trades or businesses can elect out by making a special election
  - Business interest disallowed can be carried forward indefinitely

Interest Expense Limitation – IRC § 163(j)

- **State Tax Issues**:
  - Unlike most states, TCJA coupled the interest expense limitation to 100% expensing for cost of capital.
  - How is the limitation computed for state purposes when state and federal filing methodologies differ?
    - Conformity to consolidated return regulations
  - External vs. internal debt (especially for sep. return jurisdictions).
  - Will state allow indefinite carryforward of disallowed interest expense?
  - How will the federal limits interact with state related party interest expense disallowance statutes?

Wayfair and State Responses

The *Wayfair* Decision: June 21, 2018

– In a 5-4 Decision, Justice Kennedy (joined by Thomas, Gorsuch, Ginsburg, Alito) held that:
  - *Quill* and *National Bellas Hess* are overruled
  - The physical presence rule is unsound, is an incorrect interpretation of the Commerce Clause, and restricts the states' authority to "collect taxes and perform critical public functions"

– Concluded that the following features of South Dakota's law minimized the burdens on interstate commerce:
  - Included a transactional safe harbor ($100k or 200 transactions)
  - Did not apply retroactively
  - South Dakota was a full member of the Streamlined Sales and Use Tax Agreement (SSUTA)

What Is Replacing the Physical Presence Test?

– "For these reasons, the Court concludes that the physical presence rule of Quill is unsound and incorrect".

– "Here, the nexus is clearly sufficient based **on both the economic and virtual contacts** respondents have with the State."
  - "And respondents are large, national companies that undoubtedly maintain an extensive virtual presence. Thus, the substantial nexus requirement of Complete Auto is satisfied in this case."

– What is the "economic and virtual" presence test?

Wasting No Time

Over 30 states have **already** provided some type of "economic nexus" guidance.

- Alabama
- Connecticut
- Colorado
- Georgia
- Hawaii
- Illinois
- Indiana
- Iowa
- Kentucky
- Louisiana
- Maine
- Massachusetts
- Michigan
- Minnesota
- Mississippi
- Nebraska
- New Jersey
- North Carolina
- North Dakota
- Nevada
- Ohio
- Oklahoma
- Pennsylvania
- Rhode Island
- South Carolina
- South Dakota
- Utah
- Vermont
- Washington
- Wisconsin
- Wyoming

Transactional Safe Harbor

- South Dakota's transaction safe-harbor of an annual threshold of 200 sales or $100,000 in sales was sufficient
  - Should the threshold be the same for California as South Dakota?
  - Can states require small businesses making few sales to collect in all cases?
  - Will there be a "de minimis" exception?
- Will the Due Process Clause become more important in state tax litigation?
- Will Congress intervene? Nexus standard? Simplification?

Retroactivity

- Not really dealt with, despite emphasis in oral argument
- South Dakota law foreclosed retroactive application
- What will other states do?
- Additional retroactive tax issue with sales/use tax is consumer obligation to self-report tax -- imposing retroactive tax could result in double taxation (is availability of a refund sufficient) on remote sellers

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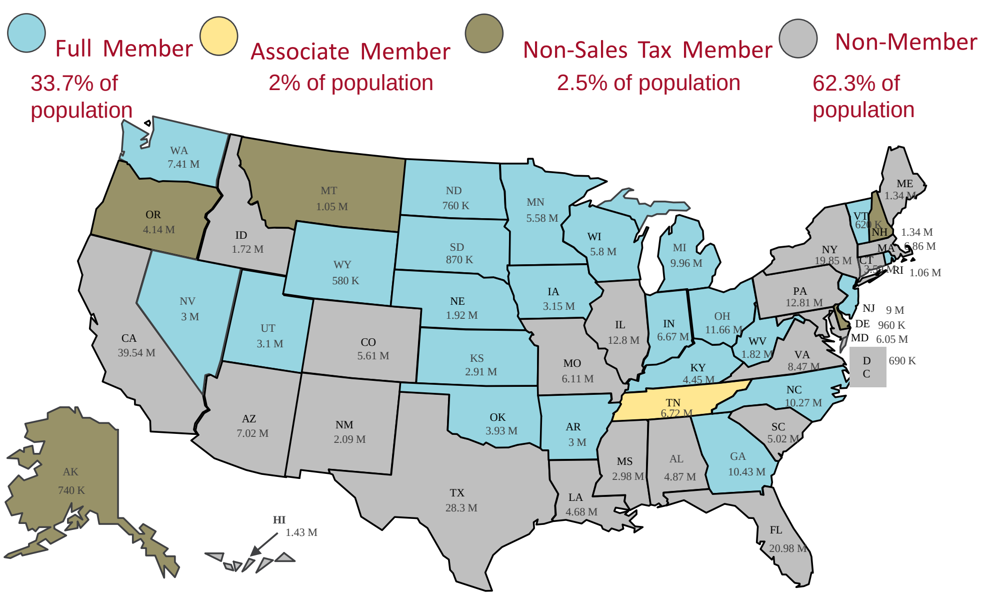
Will More States Join SSUTA: Streamlined Sales Tax States by Population



Source: U.S. Census Bureau

Will State "Platform" Laws Be the Hot Legislative Item in 2019?

– A quickly growing trend in the sales tax arena is the adoption of "marketplace facilitator" laws. **In general, these laws impose collection and/or reporting obligations on a "marketplace facilitator" or "marketplace providers" for sales made by "marketplace sellers."**
  - Connecticut
  - Minnesota
  - New Jersey
  - South Dakota
  - Washington

Thank you!

John Paek
(650) 856-5548
john.paek@bakermckenzie.com

Brian D. Rose
(213) 553-1347
brrose@deloitte.com