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State Income Tax Implications of Base Broadening Components of House and Senate Tax Reform Bills

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Summary

While there are differences between the House and Senate tax reform bills that remain to be worked out between the two chambers, both bills are positioned to broaden the tax base and reduce the tax rate. This article highlights the possible impact on state income tax liabilities stemming from the base broadening provisions.

In Depth

On November 16, 2017, the US House of Representatives passed the Tax Cuts and Jobs Act of 2017. On December 2, 2017, the US Senate passed an amended version of the House bill. While there are differences between the two bills that remain to be worked out between the two chambers, the approach to tax reform taken by both bills is to broaden the tax base and reduce the tax rate, with increases in taxable income caused by the base broadening provisions tempered by a reduction in the corporate tax rate from 35 percent to 20 percent. Because most state income tax regimes key off of taxable income for federal income tax purposes, the base broadening provisions of the federal tax reform bills will have implications for state income taxes, but without the tempering of the federal rate reduction. This article highlights the possible impact on state income tax liabilities stemming from the base broadening provisions in the two tax reform bills.

Deemed Repatriation of Foreign Earnings

Both the House and the Senate bills would treat as Subpart F income the amount of the undistributed, not previously taxed post-1986 foreign earnings and profits of certain US-owned businesses (the “deemed repatriation”). Both bills would allow deductions for a percentage of the deemed repatriation such that the effective tax rates would be reduced to approximately 14 percent for foreign earnings held in cash or cash equivalents and approximately 7 percent for earning held in illiquid assets. The amount of the deemed repatriation, net of the deduction, presumably would result in an increase in taxable income. While the provisions allow for payment of tax in installments over a number of years, the inclusion in Subpart F income and income of the deemed repatriation comes in the last tax year of the taxpayer that begins before January 1, 2018.

Anti-Base Erosion Provisions

Both bills have anti-base erosion provisions that would require the inclusion in gross income of excess returns associated with the foreign exploitation of intangible property. The Senate version would require the inclusion income of “global intangible low-taxed income” (GILTI) with a 50 percent deduction (reduced to 37.5 percent for tax years beginning after 2025). This is similar to the House provision which requires the inclusion in income of 50 percent of the foreign high return amount. These provisions would require the inclusion in gross income of amounts in excess of a given rate of return on tangible assets.

Full Expensing of Certain Property

Currently, under Section 168(k), taxpayers are allowed to deduct 50 percent of the adjusted basis of qualified property placed in service during the taxable year. Qualified property generally includes property having a useful life of 20 years or less and computer software. Both bills would increase the deduction to 100 percent for five years. Naturally, this would have a dramatic reduction in taxable income for many capital intensive companies.

Section 174 Deduction for Research and Experimentation Expenditures

Under current law, taxpayers are allowed a deduction for research and experimentation (R&E) expenditures. Under both the House and the Senate bills, for R&E expenditures made during tax years beginning after 2022, such expenditures would be required to be capitalized and amortized over a period of five years. This will result in significant reductions in the R&E expenditure deduction in the early years of this requirement with a concomitant increase in taxable income.

Repeal of the Section 199 Deduction for Domestic Production Activities

Current law allows a deduction equal to 9 percent of the taxpayer’s qualified domestic production activities. Both the House and Senate bills would repeal this deduction. Repeal of the deduction will result in an increase in taxable income on the federal return.

Limitation on the Deductibility of Business Interest

Under current law, subject to a number of limitations, interest paid or accrued by a business generally is deductible in the computation of taxable income. With certain differences, both the House and Senate bills would limit the deduction for business interest to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year. These provisions could result in the reduction of the interest expense deduction resulting in an increase in taxable income on the federal return.

Deduction for Dividends from Foreign Subsidiaries

In moving to something in the nature of a territorial tax system, both bills would allow a 100 percent deduction for dividends received from foreign subsidiaries. At first blush, one would think there would be no increase in federal taxable income because the deduction rate is 100 percent. Because of the GILTI in the Senate version and inclusion of the foreign high return amount in the House version, the dividends received deduction, effectively, only provides a tax benefit for the amount attributable to the routine return on tangible assets excluded from those anti-base erosion provisions.

Effects on State Income Taxes

These provisions likely to result in increases in taxable income discussed above are just a sampling of the numerous provisions in both the House and Senate bills that could cause increases in the amount of taxable income on the federal return, which, as noted, is, for many states, the starting point in determining taxable income for state income tax purposes.

Some, but not all states, tax Subpart F income. Presumably, the deductions will also flow through to the states taxing such income, providing a reduced tax rate at the state level as well. However, absent a change in law, the full tax will be due in the year the income is reported. For states that do not tax Subpart F income, but have decoupled from the federal dividend received deduction, this income may be taxed when actually distributed or may receive a full or partial deduction at that time. To the extent the federal rules accelerate distributions to a US parent, even states that do not tax Subpart F income thus may receive a benefit. Questions regarding E&P calculations on such income may be more than difficult.

GILTI could be taxed by a state regardless of its conformity to Subpart F, unless water’s edge definitions or some other deduction related to foreign income allows an exclusion from taxable income. If the income is included, fair apportionment issues may arise. The concept of apportionment is further complicated because only a percentage of this income is included in the base. The inclusion could be further complicated by the interplay with state addback statutes. Some increase in at least the sales denominator should be allowed, but it is unclear under what mechanism this could occur or how it would be calculated.

On the 100 percent expensing issue, many states already either decouple from or significantly modify the existing 50 percent deduction under Section 168(k). Given the potential magnitude of the impact of this benefit on state tax revenues, it is likely state legislatures will respond with additional decoupling or modifications. If and when they do so, it will result in additional complexity by giving rise to differences in adjustments to basis for state and federal purposes and book-to-tax differences for financial reporting purposes.

Some states have already decoupled from the Section 199 deduction, so the federal repeal will not affect such states.

The limitation on the interest deduction should affect every state unless it proactively decouples—which seems unlikely as the change increases the base. The limitation will be complicated by the interplay with intercompany addback statutes.

States and corporate taxpayers have barely begun to grapple with these concepts and the situation remains fluid.