Federal tax reform will have a significant and possibly unexpected impact on state taxes, including on individual deductions and, for corporations, reporting methods and limitations regarding net operating losses and interest expense.

On December 22, 2017, US President Donald Trump made tax reform official, inking his signature to HR 1, the 2017 tax legislation formerly known as the Tax Cuts and Jobs Act (the Act). The new law represents one of the most sweeping overhauls to the Internal Revenue Code (IRC) in US history. The president touted simplifying the IRC and promoting the US economy as the major goals of the Act.

The Act’s federal income tax implications are of course substantial, but the state tax implications of the Act are equally vast. This is because most states conform to the IRC in some fashion—usually starting the state corporate income tax with a version of taxable income as determined under the IRC.

The following are some of the ways the new federal tax legislation will affect state taxes.

**State and Local Tax Deduction**

Possibly the most widely discussed change impacting individuals is the limitation of the State and Local Tax (SALT) deduction. For tax years beginning after December 31, 2017, the SALT deduction is capped at a total of $10,000 for income, property, and other previously uncapped taxes.

The Act specifically bars a taxpayer from prepaying 2018 state and local income taxes, but it does not limit the prepayment of real property taxes. This “loophole” left many taxpayers scrambling to do year-end tax planning by prepaying 2018 property taxes in order to take a full, uncapped deduction for those payments on their 2017 returns. Then, via a last-minute news release, the IRS claimed that a taxpayer may only take a 2017 uncapped deduction for prepaid 2018 real property taxes if the taxes were assessed before January 1, 2018 (i.e., the taxpayer could not simply estimate and pay 2018 real property taxes).

The news release does not carry the force of law—however, several states reacted quickly to conform. For example, New York Governor Andrew Cuomo (D) signed an executive order in the final weeks of December, allowing local authorities to issue tax warrants for 2018 real property taxes. In addition, a group of Democrats from high-tax states have written a letter to the IRS Acting Commissioner objecting to the release. It will be interesting to see if the IRS changes its tune before the April 15 filing deadline to allow additional uncapped prepaid property tax deductions.

With the 2017 tax year behind us, many states are looking to the future impact of the SALT deduction limitation and considering alternatives. For example:

- New York plans to challenge the law as unconstitutional double taxation of New Yorkers’ income. If unsuccessful, Governor Cuomo has suggested a “major shift” away from the current New York personal income tax laws in favor of fully deductible payroll taxes imposed directly on employers.

- California has introduced SB 227, allowing taxpayers to make donations to the “California Excellence Fund” instead of paying California income tax. Californians would compute their income tax liability, but instead of paying the tax, they could elect to donate that amount to the fund. They would then receive a fully...
deductible credit in the amount of the “donation” that can be used to offset federal tax liability.

It is promising that California and New York, two of the states hardest hit by the SALT limitation, have expressed the willingness and intent to act quickly on behalf of taxpayers with such deliberate and creative solutions. Bipartisan legislation to restore the SALT deduction has also been announced by two members of the House of Representatives.\[7\]

That said, these changes are complicated and will require extensive modifications to state law. We are staying close to these developments as they evolve.

**Federal Conformity**

Turning to corporate taxes, a linchpin factor for each state will be how it conforms to the IRC. There are two general regimes of IRC conformity among the states: fixed-date conformity and rolling conformity.\[8\] Among these two regimes, each state has its own unique rules around conformity with specific provisions of the IRC.

- Fixed-date conformity states like California and Virginia adopt the IRC as of a particular date.\[9\] States like these will have to change their laws to affirmatively adopt the IRC as amended by the Act. Otherwise, taxpayers will continue to file their “fixed-date conformity” state returns based on an earlier version of the IRC.

- Rolling conformity states like Massachusetts and New York automatically adopt the currently enacted version of the IRC.\[10\] States like these will have to affirmatively decouple from any provisions in the Act that they do not want to adopt.

The Act lowers the federal tax rate to 21% but also purports to combat tax “base erosion” by expanding the federal income tax base. Without a corresponding decrease in a rolling conformity state’s tax rate, such states will likely see an increase in corporate tax revenues because of the expanded federal income tax base, which serves as the starting point for calculation of state income taxes. Despite numerous state budget deficits across the United States, such a windfall could be politically unpopular. Each state will have to weigh the political ramifications of a windfall against the fiscal impact, and adjust its laws accordingly.

The takeaway here is that state income taxes are likely to become a much larger piece of a company’s overall tax burden—especially in states with high corporate income tax rates such as California, Pennsylvania, New Jersey, and New York.

**Reporting Method**

It is also critically important for businesses to understand how the Act’s impact can vary based on each state’s required tax reporting method. State reporting methods can be put into three categories, with varying issues depending on the state’s conformity with the Act:

1. State return requires the same consolidated group as federal return
   - Issue: State still likely decouples from certain federal provisions so state tax base could differ from federal tax base

2. State return requires combined filing that includes some, but not all, federal consolidated entities
   - Issue: Nuances for multiple unitary group filings, stacked returns, and water’s-edge filings—nuances could produce varying and unexpected results

3. State requires separate tax return for each legal entity doing business in the state
   - Issue: State still likely decouples from the federal consolidated return regulations, producing additional layers of complexity in applying the provisions of the Act, e.g., where limitations and other tax items are determined on a consolidated basis rather than separate company basis for federal income tax purposes

**Interest Expense Limitation**

Subject to a number of significant exceptions, the Act generally limits a corporation’s deduction of business interest expense in any year to the sum of business interest income plus 30% of adjusted taxable income plus certain floor plan financing interest.\[11\] Most states already disallow the deduction of interest paid to affiliates via laws commonly referred to as “add back” statutes or effectively disallow the deduction via combined
reporting regimes. Issues could include the following:

- Possible double counting/double taxation on interest expense paid to affiliated entities in “add back” states.
- The new federal limitation on the interest deduction paid to unaffiliated lenders could produce state income tax increases for many taxpayers.

Net Operating Loss Carryforward Limitation

The Act imposes an 80% limitation on the net operating loss (NOL) deduction, repeals NOL carrybacks, and allows for an unlimited NOL carryforward.[12] Some states currently apply their NOL carryforward deduction before apportionment, while others require that the deduction be made after apportionment. Generally, conformity to the 80% limitation will increase the state tax burden for companies that previously deducted all of their NOL carryforwards on their state returns. Other potential issues include the following:

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

Foreign Dividends and Deemed Repatriation of Earnings and Profits

The Act provides for a participation exemption whereby certain dividends that a US corporation receives from a foreign corporation are 100% excludable from taxable income.[13] The Act also reduces the dividends received deduction (DRD) percentages to reflect the economic impact of the decrease in the federal corporate income tax rate.[14] While taken together these two changes present no constitutional infirmity from a federal perspective, states that adopt these provisions could run afoul of the nondiscrimination principles most notably articulated by the US Supreme Court in *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance.*[15]

On a similar note, the Act creates a deemed repatriation of previously untaxed, undistributed foreign earnings and profits (E&P) under IRC Section 965, which falls within Subpart F.[16] While many states exclude Subpart F income from their taxable income calculation, states that do not exclude Subpart F income may still exclude the Act’s deemed repatriation income under the state’s DRD, which brings one back to the above-cited constitutional quandary.

Like-Kind Exchanges Limited to Real Property

Gains and losses from “like kind” exchanges (LKE) of non–real property (e.g., machinery, equipment, vehicles, intellectual property, and other intangible business assets) are no longer treated as nonrecognition items for federal tax purposes. Rather, LKE deferral is only permitted on the exchange of real property. This is a drastic change and taxpayers that have robust LKE programs should consider the following, among other questions and issues:

- How do taxpayers determine what is “real property” vs. “tangible personal property”? Do they interpret this under state law or federal law?
- Do the Act’s provisions that allow for “full expensing” offset the elimination of the gain deferral? What about intangible property and tangible personal property excluded from the full expensing provision?
- Could differing treatment in rolling conformity vs. fixed conformity states cause inconsistent accounting and reporting? Are there traps and/or opportunities for taxpayers in states without rolling conformity?

Takeaways

We don’t yet know the full span of how states will react to the Act, but we can be certain of one thing: The impact on state corporate income tax burdens will be substantial, especially in states with high corporate income tax rates. Much of the complexity and uncertainty at the state level will be in the areas where state law differs from federal law—and there will certainly be both “winners” and “losers”.

[2] HR 1 § 11042; N.B. This limit applies only to individual taxpayers, not other taxpaying entities.

[3] Id.


[5] Id.


[8] N.B. Some schools of thought would add a third category—specific conformity—which is a variant of either fixed-date or rolling conformity.


[12] HR 1 § 13302.

[13] Id. at § 14101.

[14] Id. at § 13002.


[16] HR 1 § 14103.

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