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Businesses Beware: SALT Effects Of Tax Reform May Vary

By **Craig Fields, Irwin Slomka and Kara Kraman** (February 26, 2018, 4:52 PM EST)

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The Tax Cuts and Jobs Act, generally effective for tax years beginning on or after Jan. 1, 2018, made many significant changes to the federal tax code. While the state and local tax implications of federal tax reform on individuals has received a lot of attention, some of us would argue that the more meaningful — and more permanent — changes are to the taxation of businesses. What follows is a summary of the more significant provisions affecting those businesses and business owners and their state tax implications.

Reduction of Corporate Income Tax Rate

Perhaps the most significant federal change effected by TCJA is the reduction of the top corporate income tax rate from 35 percent to 21 percent. While this rate reduction does not have direct state and local tax implications, it does have some indirect implications.

Such a rate reduction at the federal level may make state corporate income taxes a larger consideration for corporate taxpayers, which in turn may lead to increased pressure on states to offer competitive corporate income tax rates. On the flip side, it may also cause states to determine that some of the federal tax savings afforded to corporations are up for grabs at the state level. For instance, in California a bill was introduced on Jan. 18 which would amend the state constitution to create a 10 percent tax surcharge on a corporation's net income over $1 million.[1] The bill's sponsors explicitly stated that the increased tax on large corporations is in response to the federal rate cuts. Another example of this can be found in New York, where the governor's 2018-2019 proposed executive budget bill (Part DD) contains a "healthcare insurance windfall profit fee," which is an additional 14 percent fee — in addition to the regular tax imposed on corporations doing business in New York — imposed on the net underwriting gain from health insurance sales in New York. The memorandum in support of the budget bill explicitly ties the fee to the federal rate decrease.

Limitation on Interest Expense Deduction

TCJA generally limits the deduction for net business interest to 30 percent of the taxpayer's adjusted taxable income for the year.[2] This limitation, which only applies to taxpayers with average annual gross receipts of $25 million over a three year period, generally does not apply to small businesses.[3] The amount of any business interest not allowed in one year may be carried forward indefinitely to

future years.[4]

Because in most states the computation of state taxable income begins with federal taxable income, the interest expense deduction limitation will generally also apply at the state level, increasing the state tax base. The adoption of the interest expense limitation, however, has the potential to create issues at the state level which do not exist at the federal level. For example, how should taxpayers apportion the carryforward amounts of unused interest expense deduction when the apportionment percentage is different in the year interest expense was incurred than in the year in which it is recognized? In addition, the interaction of the interest expense limitation with state interest add-back provisions could lead to unintended results in which the full amount of interest expense is added back to a taxpayer's state taxable income, even though the full amount is not deducted from its income. This could occur, for example, where the interest deduction is limited to the amount allowable federally, but the add-back is for amounts "paid."

Other Changes to the Federal Tax Base

Immediate Expensing. TCJA provides that bonus depreciation of 100 percent is permitted for qualified property placed in service between Sept. 27, 2017, and Jan. 1, 2023, after which the special bonus depreciation provision begins to phase out.[5] While many states long ago decoupled from bonus depreciation, states that have not decoupled could see a revenue loss from this provision unless they take action to decouple. It is worth noting, however, that states that do not allow immediate expensing, but that adopt the federal interest deduction limitations, will increase the tax burden on businesses by eliminating the counter-balance provided by immediate expensing and reduced corporate tax rates.

Net Operating Losses. TCJA limits the deduction for net operating losses to 80 percent of taxable income and eliminates the net operating loss carryback.[6] While many states are already decoupled from the federal net operating loss rules, those states that have not previously decoupled will need to determine whether to do so.

Treatment of Pass-Through Entities and Their Income

One of the more significant changes TCJA makes is to the treatment of certain income from pass-through entities — i.e., partnerships, S corporations, limited liability companies that elect to be treated as partnerships and sole proprietorships. As this change is technically a change to the individual income tax code and not the corporate tax code, unlike the other corporate income tax provisions discussed in this article, this provision sunsets on Jan. 1, 2026.[7] Specifically, TCJA provides for a 20 percent deduction for noncorporate owners for qualified business income from a pass-through entity. The deduction is only available for "qualified business income."[8] It is generally not available to owners — above certain income levels — of most service-related businesses, including health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services businesses.[9] In addition, the definition of qualified business income eligible for the deduction does not include payments for services — including guaranteed payments to partners for services — and most investment related income.[10] The deduction is subject to certain limitations based on W-2 wages paid by the entity and/or on a percentage of the unadjusted basis of all qualified property of the entity.[11]

The deduction is allowed against an individual's federal taxable income rather than against the individual's federal adjusted income, a distinction which is significant when determining how it applies at the state level.[12] In general, if the starting point for an individual's taxable income at the state level is federal adjusted gross income, then the 20 percent deduction will have no impact at the state level.

This is because the deduction is structured as a deduction against federal taxable income, not adjusted gross income. For the handful of states that do start with federal taxable income, e.g., Colorado, the 20 percent deduction will be incorporated into those states' tax codes unless they decouple from this provision.

Moreover, in states that do adopt the 20 percent deduction, such adoption may result in corporate owners being taxed on their pro rata share of pass-through income at a higher effective state tax rate than individual owners are taxed. This is because the corporate owners will not receive the 20 percent deduction nor — unlike under the new federal regime — will they receive the benefit of a reduced state corporate tax rate.

International Tax

In general, TCJA shifts the United States away from what was a worldwide system of taxation under which corporations were generally taxed on all of their income, whether earned in the United States or abroad, to what is called a "territorial" system of taxation under which only income earned within the United States is subject to taxation. The international tax provisions set forth in TCJA are complex and their implications at the federal level are still being analyzed. For purposes of this article, we focus on the state and local tax implications of three of those provisions: the one-time repatriation tax, the tax on global low-taxed intangible income and the 100 percent dividends received deduction for foreign source dividends.

One-Time Repatriation Tax. A one-time repatriation tax is imposed for the 2017 tax year. It subjects to tax income previously earned by controlled foreign corporations, or "CFCs", but that has not yet been included in the taxpayer's federal taxable income under subpart F of the IRC.[13] The repatriation tax is imposed at a lower rate — either 8 percent or 15.5 percent — than the regular corporate tax rate of 21 percent. However, this lower rate is not accomplished by simply subjecting the repatriation amount to tax at a lower rate. Instead, a repatriation addition amount is first calculated, reflecting a corporation's deferred income from CFCs, and then a repatriation deduction is calculated that results in tax being imposed at an effective rate of either 8 percent or 15.5 percent.[14] The taxpayer can elect to defer payment of its repatriation tax liability by paying it in eight installments, but it recognizes the income in 2017.[15]

Most states use federal taxable income as the starting point for a corporation's state taxable income, so the repatriation addition amount will generally be included in a taxpayer's state tax base unless there is a state modification to federal taxable income which would exclude the amount, such as an exclusion for subpart F income, or in those states that do not conform to the current IRC. States that start with federal taxable income will generally also include the repatriation deduction amount, unless there is a specific state provision adding it back. Because the repatriation addition amounts and deduction amounts are calculated separately, there may be situations where a state includes the repatriation deduction amount, but not the addition amount, resulting in a huge windfall for the taxpayer — e.g., where a state has a provision excluding subpart F income from state taxable income, but has no provision that would add the repatriation deduction amount back. The opposite result may also be possible depending on the state's law — a taxpayer could include the repatriation addition amount in its income, but would not receive the repatriation deduction amount. In addition, unlike under the new federal law, there does not currently exist a mechanism under state tax laws allowing a taxpayer to pay the resulting state tax over eight years.

Global Intangible Low-Taxed Income or "GILTI." The calculation of GILTI is based on a complex formula

that exempts from inclusion a deemed return on depreciable assets, and deems the remaining income — with several categories of income excluded — to be intangible income that is subject to current U.S. taxation.[16] While GILTI is generally taxed to corporations at a reduced rate of 10.5 percent, like the repatriation tax provisions discussed above, GILTI is not simply taxed at a lower rate. Instead a "GILTI addition" is calculated, and then a "GILTI deduction" is calculated, which, when taken together, result in the lower effective tax rate.[17]

Potential state and local tax issues exist for amounts taxable as GILTI similar to those relating to the one-time repatriation tax. Since most states start with federal taxable income, the GILTI addition will generally be included in a corporation's state tax base, unless it is specifically excluded. However, unlike the repatriation addition amount, GILTI specifically is not characterized subpart F income, so it will not automatically be excluded from state taxable income simply because a state excludes subpart F income. The GILTI deduction will be allowed in computing a corporation's state taxable income if the state law uses taxable income after special deductions as the starting point, because unlike the repatriation deduction, the GILTI deduction is characterized as a special deduction under the IRC.

One Hundred Percent Dividends Received Deduction for Foreign Source Dividends. After application of the one-time repatriation tax for 2017, for tax years starting on or after Jan. 1, 2018, a domestic C corporation that owns 10 percent or more of a foreign subsidiary will be able to take a 100 percent dividends received deduction for the foreign-source portion of dividends received from the 10 percent owned foreign corporation.[18] The DRD is not available for dividends received by real estate investment trusts and regulated investment companies, and there are certain holding period requirements that must be satisfied.[19]

For states that start with federal taxable income, such dividends will likely now be excluded from tax since they are no longer included in federal taxable income.

Conclusion

To determine the state tax implications of a particular provision of TCJA will require determining to what extent a state conforms to a particular provision of the IRC. This includes a careful examination of the language of the relevant state statute and regulations. As TCJA was only recently signed into law, most states are still studying its implications, and as of this writing have not yet changed their laws. As we keep an eye on future developments, we expect to see many states addressing these issues directly, not only legislatively, but also through regulations and other guidance.

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[1] Assemb. Constitutional Amendment 22, 2017-18 Leg., Reg. Sess. (Cal. 2018).

[2] I.R.C. § 163(j)(1)(B).

[3] I.R.C. § 163(j)(3).

[4] I.R.C. § 163(j)(2).

[5] I.R.C. § 168(k)

[6] I.R.C. § 172(a)(2), (b)(1)(A).

[7] I.R.C. § 199A(i).

[8] I.R.C. § 199A(c)(1).

[9] I.R.C. §§ 199A(d). It may not always be clear if a business is a "service trade or business," which in addition to several enumerated fields, includes "any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees." 1202(e)(3)(A).

[10] I.R.C. § 199A(c).

[11] I.R.C. § 199A(b)(2). This limitation does not apply to taxpayers with taxable income less than or equal to $157,500 — $315,000 for married couples filing jointly.

[12] I.R.C. § 199A.

[13] I.R.C. § 965(a).

[14] I.R.C. §§ 951, 965.

[15] I.R.C. § 965(h)(1).

[16] I.R.C. § 951A.

[17] I.R.C. §§ 250, 951A.

[18] I.R.C. § 245A(a).

[19] I.R.C. § 245A; 246(c).