27th ANNUAL

PAUL J. HARTMAN

STATE AND LOCAL TAX FORUM

VANDERBILT UNIVERSITY LAW SCHOOL

TCJA: States' Reaction and COVID-19-Responsive Tax Provisions

October 27, 2020

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Agenda

- Update on key TCJA state tax issues for multinationals
- State tax impacts of cross-border transactions, post TCJA
- State response to the CARES Act and COVID-19

State update on key TCJA issues for multinationals

Section 163(j) limitation

- Limits deduction for business interest expense to the sum of:
  - Allowable Interest Expense Deduction = Adjusted Taxable Income (ATI) * 30% + Business Interest Income + Floor Plan Financing Interest Expense
    - CARES Act increases the ATI limit to 50%
- Allows indefinite carryforward of disallowed interest deductions
- Provides that the limitation applies to both related-party and unrelated-party debt
- Pass through entities-Section 163(j) is applied at the pass-through level
- Exemptions (among others): Certain regulated utilities (electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline

Section 163(j) limitation

- ATI is the taxable income of the taxpayer—
  - (A) computed without regard to
    - (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
    - (ii) any business interest or business interest income,
    - (iii) the amount of any net operating loss deduction under section 172, (iv) the amount of any deduction allowed under section 199A [qualified business income of pass-through entities], and
    - (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and
  - (B) Computed with such other adjustments as provided by the Secretary

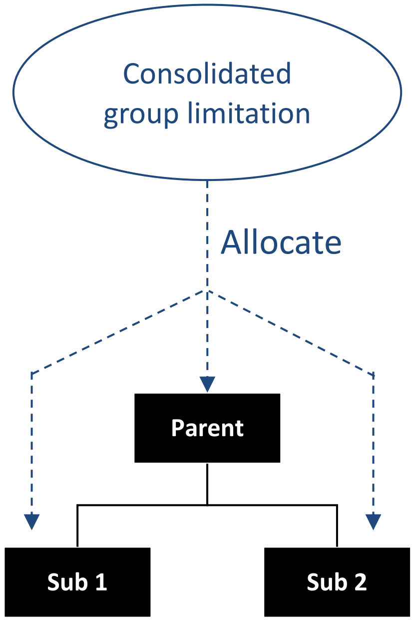
Section 163(j) limitation

- Applies on the consolidated group filing level:
  - Group Adjusted Taxable Income
    - Calculation begins with consolidated taxable income
    - Without regard to items noted above and without regard to intercompany transactions or obligations
  - Interest
    - Interest arising from intercompany obligations is disregarded
  - Allocation to Group Members
    - If the Section 163(j) limitation is less than the group's aggregate business interest expense, a member first deducts its current-year business interest expense (BIE) (up to its business interest income (BII) and floor plan financing interest (FFI)), and to the extent there is remaining limitation, its remaining BIE on a pro-rata basis

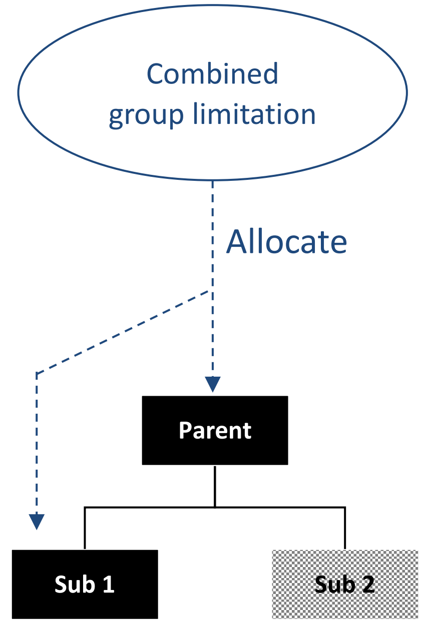
Section 163(j) limitation and state conformity

- Does the state adopt new Section 163(j)?
  - If have not adopted the new provisions the old Section 163(j) limitations may apply.
  - If decoupled may not have any limitations
- Is the state limitation really 30% or 50% of state taxable income?
  - The ATI definition is a federal definition and states should follow but there may be adjustments for computing state taxable income?
- In general how is the state limitation computed?
  - Separate company states;
  - Consolidated states;
  - Combined reporting states that do not adopt the federal consolidated return regulations

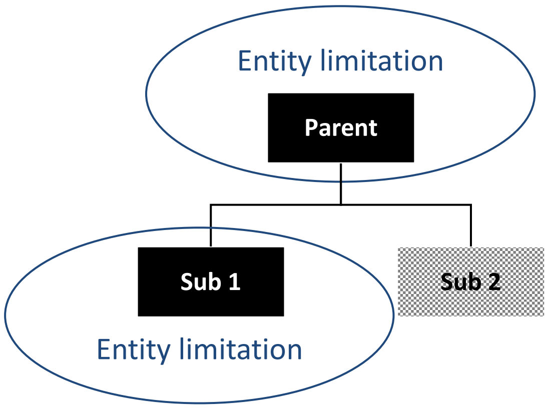
Section 163(j) limitation and state conformity



Federal "as filed" calculation



Combined group calculation



Separate entity calculation

Section 163(j) limitation and state conformity

- Ordering of the state addback rules
  - Before the determination of deductible interest under Section 163(j) or after the determination has been made
- Interplay between related party interest expense, addback provisions, and interest expense limitation
  - If the entity has both intercompany and third party interest expense, what portion of the post-limitation deduction is subject to addback
  - How do the exceptions to the addback statutes apply?
- Tracking of disallowed interest expense amounts for carryforward purposes
- Permanent loss of interest expense deduction due to decrease in apportionment in carry over year

Section 163(j) limitation and state conformity

Key

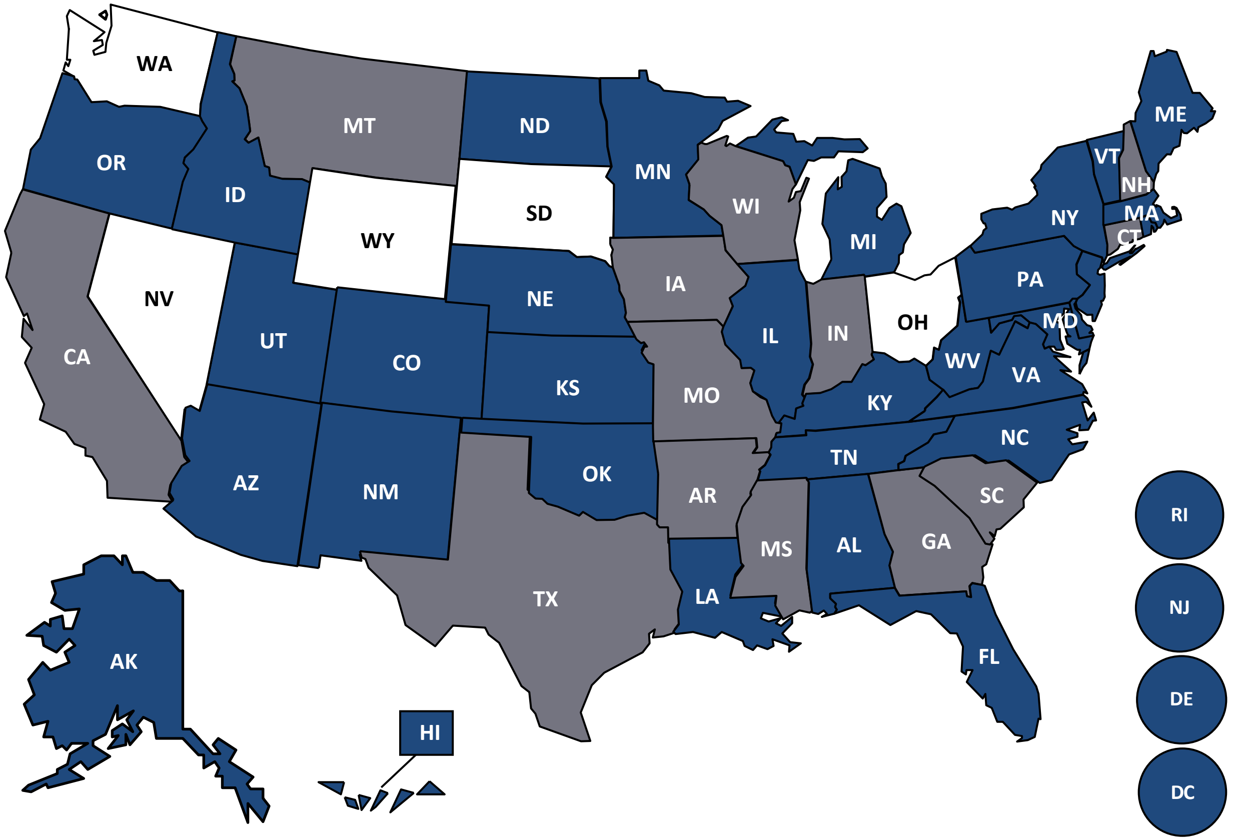
- Generally, state law does not conform to Section 163(j), as amended by the TCJA
- Generally, state law conforms to Section 163(j), as amended by the TCJA
- No corporate income tax

Iowa decouples from Section 163(j) effective beginning with the 2020 tax year.

Tennessee conforms to Section 163(j), as amended by the TCJA, for the 2018 and 2019 tax years. However, effective beginning with the 2020 tax year, Section 163(j) is applied as it existed and applied immediately before the enactment of the TCJA.

Virginia allows an additional deduction equal to 20% of the business interest disallowed as a deduction pursuant to Section 163(j), as amended by the TCJA.

For the 2019 taxable year



Source: Ernst & Young LLP analysis of state corporate income tax laws (as of September 21, 2020)

GILTI

- Purpose: to discourage U.S. companies from moving business operations to low-tax foreign countries.
- Federal rule:
  - U.S. corporation must include income certain income of a foreign corporation affiliate that is taxed abroad at a rate lower than the U.S. rate and that exceeds a 10% return on the affiliate's tangible property. Section 951A.
  - U.S. parent can deduct 50% of its GILTI (thereby reducing the effective tax rate). Section 250(a)(1)(B).
  - Partial foreign tax credit allowed to lessen tax imposed on GILTI in an effort to tax only income generated in law-tax jurisdictions.

GILTI and state conformity

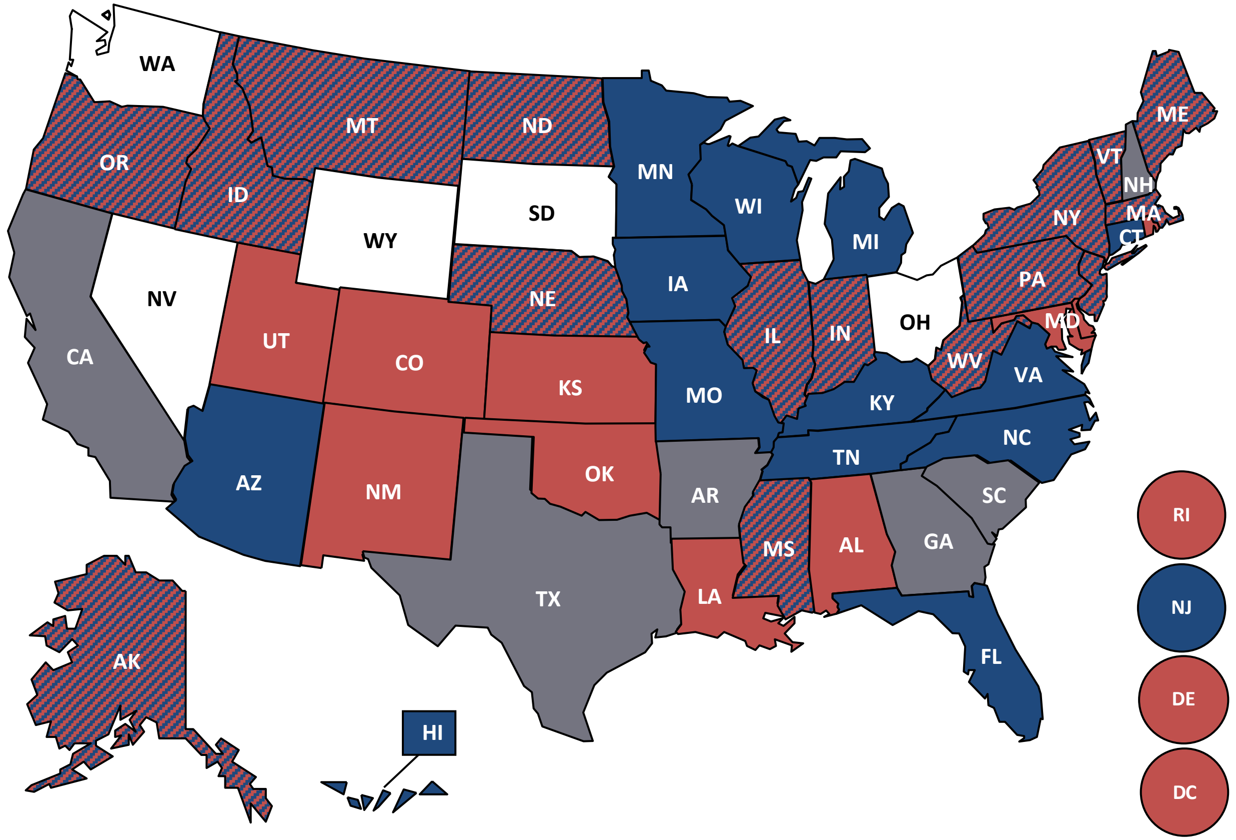
- **"Global":** The starting point is all of the global income earned by the taxpayer's foreign subsidiaries.
- **"Limited to Intangibles"**: No, GILTI includes income from services, digital products, financial services, a sizable portion of tangible property sales, and intangibles.
- **"Low-Taxed":** 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 (reduced to 37.5% after 2025) for GILTI income.
- **Offset by Corporate Tax Cuts:** No, states did not conform to federal corporate rate cuts.
- **Favor Domestic Commerce over Foreign Commerce:** No, the states are limited by the Constitution's Commerce Clause and cannot treat foreign commerce differently than domestic.
- **Displaced US domestic income**: Proponents of state taxation of GILTI are making broad and unsubstantiated assertions that GILTI is all or primarily "displaced US domestic income"?

GILTI and state conformity

Key

- Pre-TCJA fixed conformity (not taxable)
- Full modification to GILTI (generally not taxable)
- Special rules (typically impacted by percentage of ownership or state filing methodology) or partial modification*
- No modification (generally taxable)
- No state corporate income tax

For the 2019 taxable year



*Map reported prior to effects of state expense disallowance statutes.

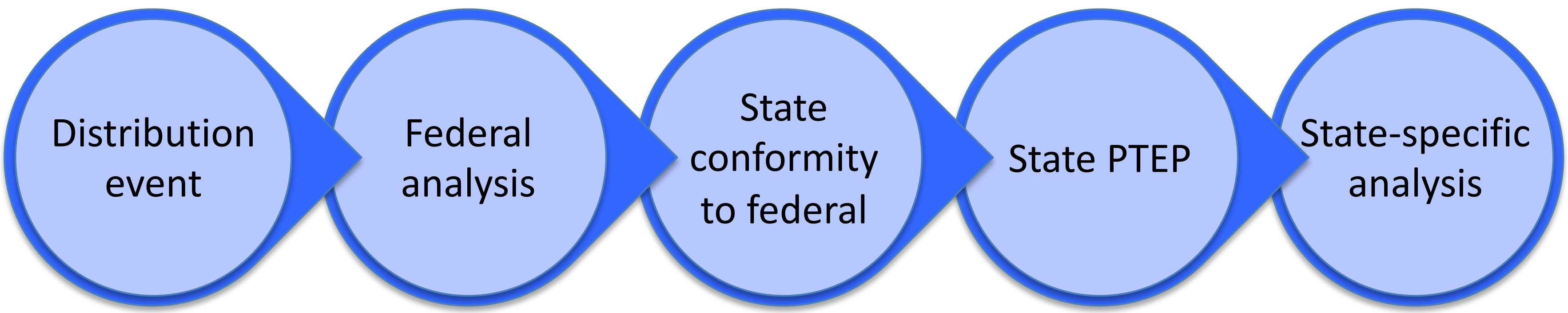
Source: Ernst & Young LLP analysis of state corporate income tax laws (as of September 21, 2020)

State tax impacts of cross-border transactions, post TCJA

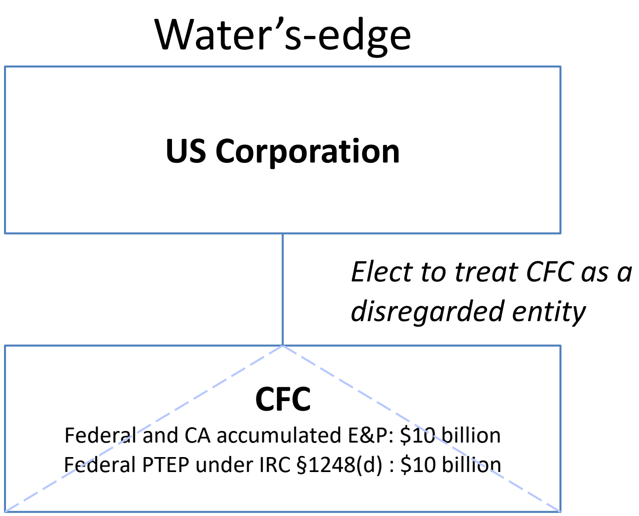
Post-TCJA distribution considerations

- Recall that distributions, including federal distributions that will not be subject to federal income tax as previously-taxed earnings & profits (PTEP), from foreign investees might result in significant income tax liabilities in certain states:
  - Certain states that did not conform to the Section 965 transition tax (the "Day 1" event) might tax foreign dividends (the "Day 2" event) of transition tax earnings, in whole or in part.
  - Certain states that do not conform to Section 245A might tax foreign dividends of pre- or post-transition tax earnings, in whole or in part.
- PTEP, E&P and stock basis may each – or all – differ for state purposes due to relevant nonconformity and related federal-state disconnects.
- Also remember that distributed E&P may have been previously taxed for only state purposes, but not for federal purposes.

Post-TCJA distribution considerations



California example: Section 367(b) pitfall



	Federal TI	California TI
Taxable dividend	$0 (all PTEP)	$10 billion (less DRD)

- Consider a conversion in which a CFC "checks the box," electing to be treated as disregarded from its sole US shareholder:
  - Assume the federal election results in an Section 332 liquidation.
  - In turn, assume Section 367(b) – which can result in a deemed dividend if a foreign corporation is merged or liquidated in a nontaxable reorganization – applies for federal income tax purposes:
    - If the CFC is a top-tier corporation, then the deemed dividend will equal the "all earnings and profits amount."
    - The all earnings and profits amount is equal to the total E&P of the CFC, less the E&P that is classified as previously-taxed income under Section 1248(d).

New Jersey example: state PTEP considerations

- N.J. Admin Code § 18:7-5.20:
  - (a) A taxpayer may exclude previously taxed subsidiary dividends from entire net income [ENI] in a tax year that:
    1. The taxpayer receives and includes in entire net income, in the current tax year, dividends from the same subsidiary for which the taxpayer had included, as paid or deemed paid dividends, in entire net income in a previous tax year; and
    2. The taxpayer filed, and paid, an amount greater than the minimum tax to New Jersey in that previous tax year.
  - (b) A taxpayer must be allowed to exclude from entire net income previously taxed subsidiary dividends upon completing and submitting Schedule PT along with their CBT100 or BFC-1, as applicable, and providing the Director of the Division of Taxation with adequate documentation of the previously taxed dividend income.

New Jersey example: state PTEP considerations

- Generally speaking, this means that the New Jersey Division of Taxation (NJ DOT) is currently not affording previously-taxed income status to deemed dividends, such as those included in income under the IRC Sec. 965 Transition Tax, if the applicable US corporate shareholder recognizing the deemed dividend did not file a NJ CBT return and pay more than the $2,000 minimum tax in the year of the deemed distribution event.
- Additionally, for tax years beginning on or after January 1, 2019, the New Jersey CBT combined reporting form (Form CBT-100U) is apportioning dividend income included in NJ ENI at the New Jersey group's apportionment factor percentage.
  - At the same time, however, the CBT return is apportioning the New Jersey dividend received deduction at the apportionment factor rate of the individual combined group member receiving the dividend.

State response to the CARES Act and COVID-19

CARES Act

- Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136) CARES Act became law on March 27, 2020.
- The CARES Act provided an estimated $2.2 trillion of stimulus to the American economy. It Included a mix of loans, grants, and government agency appropriations. Also, there were a number of direct changes to the federal income tax law, some of which temporarily modified provisions of TCJA.
- Key corporate provisions are:
  - Restoring NOL carryback and expanding it to five years for NOLs generated in 2018-2020;
  - Temporarily lifting the 80% net income offset limitations with respect to NOLs;
  - Modifying the business interest expense limitations under Section 163(j), including increasing the ATI-based portion of the limitation to 50% of ATI for 2019 and 2020; and
  - Reclassifying qualified improvement property (QIP) to make it eligible for a shorter depreciation life and therefore the 100% bonus depreciation.

State conformity to the CARES Act

- States have begun to address the implications of the CARES Act:
  - **Colorado** (HB 1420):
    - Decouples from the changes to NOL deduction rules
    - Decouples from the changes to Section 163(j)
  - **Iowa** (Omnibus Tax Bill)
    - Decouples from the changes to Section 163(j)
    - Allows a deduction for GILTI
    - Allows for a 20 year carryforward of NOLs
  - **Maryland**
    - Section 10-103 of the MD Tax Code requires an automatic decoupling if in the tax year enacted the changes would reduce revenue in excess of $5 million. Prospective decoupling creates issues with the Section 163 (j) changes which were for prior tax years.

State conformity to the CARES Act

- States have begun to address the implications of the CARES Act (cont.):
  - **North Carolina** (HB 1080)
    - Adopts the Internal Revenue Code as of 5/1/2020
    - Decouples from Section 163(j) 50% deduction
    - Decouples from the NOL provisions
  - **New Mexico** (HB 6)
    - Updates the Code to conform to TCJA
    - Decouples from the CARES Act
  - **New York** (Budget Bill)
    - For tax years beginning before January 1, 2022 any changes made to the IRC after March 1, 2020 do not apply to New York
  - **New York City** (Notice N-20-7)
    - Decouples from the CARES Act changes to IRC Sections 163(j) and 172

Virtual transformations in the COVID-19 economy

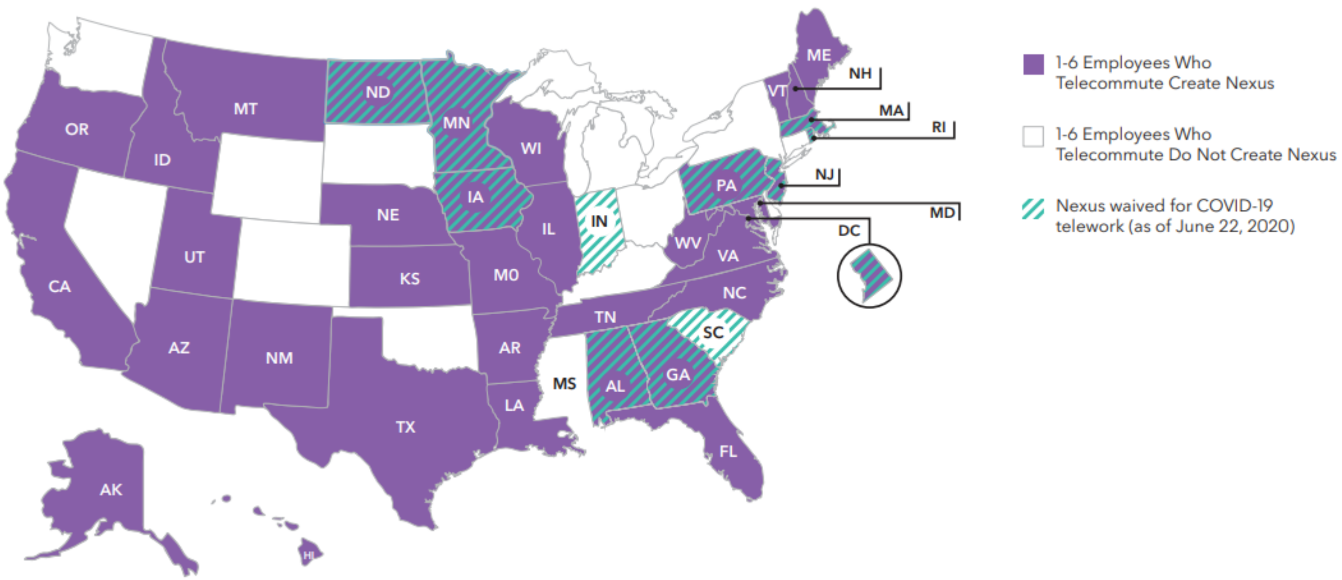
- Going virtual
  - Businesses are expanding remote workforce arrangements
    - Virtual internship programs
    - Virtual board of directors meetings
  - Decentralizing offices
  - Downsizing or eliminating real estate footprints
- The nature of work may be changing permanently

Virtual transformations in the COVID-19 economy

- Nexus
  - General approach: one employee is enough
    - *See*, *e.g.*, **California**, **Idaho**, **New Jersey**, **Virginia**
  - What does this mean for P.L. 86-272 protection?
  - Does COVID-19 impact the analysis?
  - Some states have issued COVID-19 specific guidance
    - No nexus if remote employment is temporary and due to the pandemic
    - Protection may be limited to the duration of the crisis or the time that telework requirements are in place
    - *See*, *e.g.*, **DC**, **Georgia**, **Indiana**, **Massachusetts**, **Minnesota**, **Mississippi**, **New Jersey**, **North Dakota**, **Pennsylvania**

Virtual transformations in the COVID-19 economy

Will Telecommuting Employees Create Nexus?



NOTE: DC and NYC are treated as states for purposes of this chart. OH, NV, SD, WA, and WY do not impose a corporate tax based on income. CO, DE, MI, NY, NYC, OK, and SC did not participate in this portion of the survey. As a result, these 12 states are not included in this chart.

Source: Bloomberg Tax 2020 Survey of State Tax Departments

Virtual transformations in the COVID-19 economy

- Apportionment
  - Sales factor impact
    - Services: Where is the cost of performance or time spent when the employee doing the work is at home? Where is the benefit of the service received when the customer is working from home?
    - Intangibles: Where are decisions being made? Where are the intangibles being used?
  - Payroll factor impact
    - Sourcing based on where work is performed may differ from where the employee is reported for state unemployment tax purposes
  - Property factor impact
    - Impact of equipment used by remote employees
  - Hidden risk: impact of at-home management and board members on unitary positions
- Don’t forget credits and incentives

Non-income tax considerations

- Sales tax
  - Wayfair considerations remain, physical presence remains nexus-creating
  - Sourcing of services
- Use tax
  - Software, services and equipment may be used in new jurisdictions
- Property tax
  - Both real and personal property tax assessments may be too high after decentralization
  - Elimination or reduction of property tax from eliminating office footprint
  - New personal property tax registrations and filings may be required

THANKS FOR PARTICIPATING.