

A Guide To US States' Responses To Tax Reform

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Most businesses will be state tax neutral and at worst, will wind up paying more state tax, but the cost of state tax compliance is sure to increase.

WASHINGTON, DC—As businesses across the country evaluate the impact of federal tax reform on their operations, state legislators are making similar evaluations. States have made a habit in the past of decoupling from aggressive deductions allowed for federal income tax purposes, and while federal tax reform has been viewed as a positive for businesses, it largely remains to be seen the full impact from a state perspective.

The Tax Cuts and Jobs Act ("TCJA") is major tax legislation for businesses that included accelerated expensing (100%) for tangible property, repeal of corporate alternative minimum tax, potential limitation on business interest deductions, and limitation on net operating losses, just to name a few of the changes.

Probably the most advantageous change for businesses was the lowering of corporate tax rates and the effective lowering of tax rates on pass through income.

Even states that generally conform to the Internal Revenue Code ("IRC"), do not conform to such federal tax rate changes by lowering their own rates. This, in theory, could provide a boon for states. For example, any limitation on the deductibility of interest would result in a higher tax base for states that choose to conform to the interest limitation. All things being equal, companies doing business in those states would now pay more state tax. Additionally, many states already decouple from bonus depreciation/accelerated expensing as provided for in IRC §168(k).

3 Ways To Conform

States typically conform to the IRC in one of three ways: rolling conformity whereas states automatically tie to federal tax law as it changes; fixed conformity which states tie to the federal tax law as of a specific date; or selective conformity in which states pick and choose different federal tax law provisions and dates to which they will conform to.



Stephen Bertonaschi

Make no mistake though, these types of conformity all allow for state flexibility in determining deductions in each of their jurisdictions. One of the advantages of rolling conformity is the relative ease by which the states could administer their tax code. Essentially, the state could rely on the IRS to set tax law and then enact specific decoupling modifications as they see fit.

New Jersey, as an example, has rolling conformity, but historically decouples from bonus depreciation as provided for in §168(k). The result of tax reform should be increased tax revenue for New Jersey.

In an interesting twist, New Jersey Senate President Stephen Sweeney has proposed a 3% tax surcharge on businesses with more than \$1 million in net income as a way for the State to recapture the windfall that New Jersey businesses received from Federal Tax reform (a similar proposal was made in California).

Basically, the view is that if the corporation is paying less federal tax, they should pay more New Jersey tax. Pennsylvania, another rolling conformity state, was also very aggressive in providing guidance earlier this year denying any depreciation deductions as a result

of immediate expensing under federal tax reform. This would result in no Pennsylvania depreciation deduction on assets that enjoyed 100% depreciation for federal purposes. The state has since reversed course with proposed legislation.

Louisiana doesn't have to be as aggressive. While Louisiana is a rolling conformity state, it also separately provides a federal tax deduction for corporations. The simple act of reducing the federal corporate income tax rate reduced the tax deduction available to a corporation doing business in Louisiana thereby raising their state tax liability which will undoubtedly help a struggling state budget.

While rolling conformity doesn't necessarily require a state to respond to the TCJA, fixed date conformity or selective conformity will require a lot more thought and analysis. California recently released a 461-page report (over 300 pages related to businesses) on the impact to California if they conformed to the TCJA.

Any conformity (California currently conforms to the IRC as of January 1, 2015) will not happen in 2018 and will only be made to the extent it benefits California. This is in stark contrast to Arizona, a state that lowered their corporate tax rate even before federal tax reform was in full swing. Additionally, Arizona recently conformed to the IRC as of January 1, 2017 (before the enactment of the TCJA), as a way to combat the windfall they would receive if they did conform to the TCJA, which would have broadened the tax base.

Arizona is not alone in making decisions based upon what will benefit their corporate taxpayers. Georgia decoupled from the new interest expense limitations and will provide a reduction to the corporate tax rate beginning in 2019. Florida updated the state's IRC conformity date to January 1, 2018; however, they will evaluate over the next couple of years the impact on corporate tax collections and ultimately have even provided for a refund mechanism for excess corporate tax collections.

Finally, Iowa has proposed to reduce corporate rates and change to rolling conformity in 2020 (presumably to avoid situations such as these, particularly since many of the provisions of the TCJA sunset in 2026).

Multi-state Firms Will Find Compliance Complicated

What does all this mean? Complying with the IRC is hard enough, but try complying with 50 states and countless local jurisdictions. The TCJA has increased that difficulty exponentially, especially for multi-state businesses. Something as innocuous as the repeal of technical terminations of partnerships could now result in one partnership return for federal purposes and two state partnership returns in the same year, depending upon when the states conform to the IRC.

Previously it was not uncommon for states to go long periods without changing their fixed conformity date. Generally, this did not have a significant impact as the changes to the IRC was done in a piecemeal way since 1986 and, other than bonus depreciation, did not contain major changes that would impact the states.

State Compliance Costs Will Increase

Obviously, the TCJA requires action by states. Of the 20+ fixed conformity states about half have enacted legislation and the other half have proposed legislation. Decisions are being made with state budgets in mind and the relative impact to businesses in their state. This is a delicate balancing act as most states want to attract new companies and certainly don't want to lose those already operating within their jurisdiction.

That being said, one of the takeaways thus far is that at best, most businesses will be state tax neutral and at worst, will wind up paying more state tax. Additionally, the cost of state tax compliance will be sure to increase, at least in the short term.

Stephen Bertonaschi is a managing director in the tax practice of the Real Estate & Infrastructure industry group at FTI Consulting, Inc. He may be contacted at stephen.bertonaschi@fticonsulting.com. The views expressed herein are those of the authors and are not necessarily the views of FTI Consulting, Inc.

