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MULTISTATE INCOME/FRANCHISE TAX

State tax considerations of President Biden's federal tax proposals

Tax Alert

Overview

On May 29, 2021, the United States Treasury released a general explanation of the Administration's fiscal year 2022 budget revenue proposals ("Green Book") that call for significant tax increases targeting large corporations and high-income individuals to pay for low- and middle-class tax relief and bankroll the trillions of dollars required to fund the traditional physical infrastructure projects and "human" infrastructure initiatives the Administration has proposed in its American Jobs Plan and American Families Plan.

Most state income tax regimes are affected by federal tax law changes because, for administrative ease, such state regimes tie to the Internal Revenue Code ("IRC") by either incorporating the IRC in whole or in part, or by using federal taxable income as the starting point. States with automatic or "rolling" conformity generally will adopt such changes unless there is specific state legislation enacted to decouple from federal law. Other states adopt the IRC as of a specific date, do not adopt the code provisions in totality, or provide modifications or exceptions to certain adopted provisions.

This Alert will discuss the state tax considerations associated with the federal tax proposals outlined in the Green Book.

American Jobs Plan

The Administration's corporate income tax proposals that will have a direct state tax impact will be those that change federal taxable income. Any such impact will be felt first in the rolling conformity states and may be picked up later by the fixed or static conformity states.

The following proposals would potentially have a direct impact on the computation of state corporate income tax due:

- Changes to GILTI, including repeal of the high tax exception and reduction of the GILTI deduction under section 250
- Repeal of the FDII deduction under section 250
- Disallowance of deductions made to certain affiliates under SHIELD
- Limitation of interest expense based on disproportionate borrowing in the US
- Modification to section 265 expense disallowance provision
- Disallowance of deductions/repeal of favorable amortization of certain expenditures

By contrast, the following tax proposals do not change federal taxable income and, for that reason, are unlikely to have a material direct impact on the computation of state tax:

- Raise the corporate income tax rate to 28 percent
- Impose a 15 percent minimum tax on book earnings of large corporations
- Creation of federal tax credits

However, even these proposals could have a material indirect impact on state tax to the extent they motivate the enactment of similarly focused state tax legislation. It should also be noted that states sometimes tie to federal tax provisions that are outside the federal taxable income calculation. For example, a number of states tie in some fashion to the federal New Markets Tax Credit which would be made permanent in the proposal.

Repeal of the high tax exception and reduction of the GILTI section 250 deduction

Many states currently provide at least a partial subtraction or dividend received deduction for GILTI income, with a number allowing a full subtraction. For those that do not decouple or provide a 100 percent subtraction, any federal changes that increase the amount of section 951A inclusion would correspondingly increase state taxable income.

As of the date of this publication, there are ten jurisdictions that impose tax on GILTI net of the section 250 deduction without any subtraction: New Jersey, New York City, Rhode Island, New Hampshire, Vermont, Maryland, Nebraska, Alaska, Delaware and District of Columbia. The increase in GILTI caused by the proposed repeal of the high tax exception and the reduction of the GILTI deduction under section 250 would have an outsized state tax impact, both because foreign tax credits are unavailable to offset state tax and most states do not allow full apportionment representation for the GILTI income by statute. The reduction of the GILTI deduction under section 250 would also have an impact in states that allow a less than 100% deduction against net GILTI income, as opposed to gross section 951A income.

Repeal of the FDII deduction under section 250

A repeal of deduction under section 250 for FDII would impact state taxable income in the states that currently couple to that provision of the IRC.

Disallowance of deductions made to certain affiliates under SHIELD

The BEAT has not historically affected state corporate income tax due to its nature as a minimum tax that does not affect the computation of federal taxable income. For example, even if a taxpayer paid federal tax under the BEAT, the computation of state taxable income was still based on its federal taxable income as computed under the IRC. The proposed replacement of the BEAT, referred to as SHIELD, would impact federal taxable income and, accordingly, state taxable income.

Certain types of payments that SHIELD was ostensibly intended to target, such as intercompany interest and intangible payments, have long been required to be added back to income in the majority of states under so-called “intercompany addback” statutes which date back to the early 2000’s. Intercompany addback statutes often have exceptions that allow a taxpayer to benefit from a deduction where, for example, the payment is made to an entity resident in a country with a US bilateral tax treaty, is subject to tax at a rate similar to the state tax rate (generally under 10%), or is paid out to a third party during the tax year. To the extent that the proposal would disallow a deduction in arriving at federal taxable income, there will be no expense “addback” against which to apply the addback exceptions, unless the state enacts a specific subtraction modification. It is unclear whether states will choose to maintain their existing intercompany addback regimes rather than conform to SHIELD or simply conform to SHIELD and thereby avoid the fact intensive analysis usually required to determine the applicability of addback exceptions.

Limitation of interest expense based on disproportionate borrowing in the US

The proposed additional limitation on interest expense for US members of a multinational financial reporting group may have significant state tax consequences and complexities. Many states do not follow federal consolidated return rules and either tax each entity on a separate company basis, as if no consolidated return were filed, or require combined reporting of unitary affiliates, defined in such a way that combined group composition can differ markedly from the section 1504 consolidated group. For example, it is common to have a state combined filing group that includes multiple US brother-sister corporations commonly owned by a foreign parent or, conversely, US affiliates may not file as part of the same combined group if they are not part of the same unitary business.

Under the proposal, the determination of a financial group member’s excess net interest expense is to be computed on a separate company basis, but for this purpose, a US subgroup of a multinational financial reporting group is treated as if it were a single member of that group. The proposal would define a US subgroup as a US entity that is not owned by another US entity, and any of its subsidiaries, foreign or domestic. The Green Book does not discuss how the limitation may be allocated between or among members of a US subgroup. For state purposes, this will be a crucial determination, as different members within the US subgroup may have different state tax filing obligations. For example, if a member of a US subgroup is required to file a state tax return on a separate company basis, it is unclear what ought to be its separate company taxable income if the US subgroup of which it is a part had excess net interest expense. Alternatively, these rules could result in a situation where there is a limitation that affects all members of a US subgroup based on the interest expense paid by a corporation that is not included in the combined group for which a return is filed in a particular jurisdiction.

Section 265 expense disallowance

Under the proposed changes, section 265 would be expanded to disallow previously deducted expenses allocable to dividends under section 245A and the deduction under section 250. Due to the ways some states tie state taxable income to federal taxable income, this change is problematic from a state tax perspective. Many states do not conform to section 245A or section 250 and, instead, allow their own state statutory deductions for foreign dividends or GILTI income. A large number of these states also have their own expense disallowance rules that encompass the types of disallowance contemplated by the proposed revision to section 265. The result is the potential for a distorted result where both federal and state expense disallowance rules could apply to the same income due to the way in which state taxable income is tied to federal taxable income.

Proposals to disallow deductions and repeal favorable amortization of certain expenditures
States generally do not adopt or otherwise follow federal income tax credits, and as a result, the various federal tax credit related proposals are unlikely to have any state tax impact. However, many of the Administration's proposals would create or make permanent a tax credit on the one hand while disallowing expense deductions, or eliminating the preferential amortization of certain expenditures, on the other. For example, one proposal would disallow deductions for expenses paid in connection with offshoring a U.S. trade or business. Other proposals would disallow deductions for, or eliminate favorable amortization of, certain expenditures made by taxpayers in the fossil fuel industry. Absent adoption of a state law that decouples from these deduction-related proposals, there would be a state tax impact.

Impose a 15 percent minimum tax on book earnings of large corporations
While this proposal is unlikely to have a material direct impact on the computation of state tax, a minimum tax at the federal level could motivate states to consider enacting similar provisions.

American Families Plan

The following Administration tax proposals are unlikely to have a material direct impact on the computation of state tax, because none change federal adjusted gross income or taxable income:

- Increase top marginal income tax rate to 39.6 percent for high-income taxpayers
- Tax capital gain income of high-income taxpayers at ordinary income tax rates
- Rationalize net investment income and Self-Employment Contributions Act taxes
- Enhance various worker and family-focused tax credits

Treat transfers of appreciated property by gift or death as realization events
Under the proposal, donors or deceased owners of appreciated assets would report gain on the Federal gift or estate tax return or a separate capital gains return. As such gains do not appear to increase the taxpayer's federal adjusted gross income or taxable income, as reported on IRS Form 1040, this federal tax change may not have a state tax impact. However, if these gains do increase the taxpayer's federal adjusted gross income or taxable income, the proposal would have a state tax impact. Additionally, it is possible that states could enact similar legislation to tax gains on appreciated assets transferred by gift or death. It should be noted that many states do not currently impose estate or gift taxes, and many of those that do have decoupled from the federal estate and gift tax.

The proposal also provides gains on unrealized appreciation could be recognized by a trust, partnership or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. The proposal does not indicate how these gains are to be reported by the trust, partnership or other non-corporate entity. If these gains increase the federal adjusted gross income or taxable income of a taxpayer, then states that conform to these changes will also tax these gains.

Tax carried (profits) interests as ordinary income
Most states have their own tax rates and are not impacted by changes to the characterization of the income as capital gain or self-employment income. However, there are a few states where the characterization of the income as capital gain or self-employment income may have state tax consequences. For example, certain states that tax partnerships, such as Tennessee, allow a

deduction for self-employment income. There are also a few states that have special tax rates or special deductions for capital gains.

Repeal deferral of gain from like-kind exchanges
In states that conform to these changes, taxpayers will pay additional state tax on gains that are recognized in the year of the transfer. In addition, a few states have rules that could result in recognition of the deferred gain if the taxpayer leaves the state and is no longer a taxpayer.

Make permanent excess business loss limitation of noncorporate taxpayers
Many states have conformed to the excess business loss limitations and will probably conform to making these rules permanent. A few states conformed to the excess business loss limitations for certain types of taxpayers, but not for others. For example, Illinois conformed to the excess business loss limitations for individuals, but not for trusts.

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