The 2017 Tax Cuts and Jobs Act and State Tax: Where Are We Now?
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On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act ("TCJA") into law, significantly changing the federal income tax of both individual and corporate taxpayers. A material byproduct of these changes was its effect on state tax reporting. Because nearly all states that impose a net income tax, calculate that tax by reference to federal taxable income, any change to the Internal Revenue Code will have a ripple effect at the state level. As many tax advisors have learned over the last two years, state conformity to federal changes is not automatic and can be frustratingly selective.

TCJA – A Refresher

While the TCJA made sweeping changes to both the federal tax rates and the determination of taxable income, four topics serve as the focus of this article as these are where we have seen most of the unique conformity/nonconformity issues at the state level. These include (1) taxation of foreign earnings, (2) limitations on interest deductions, (3) depreciation, and (4) the new deduction for qualified business income.

Probably more of an issue to large corporate taxpayers, the TCJA dramatically changed how foreign earnings are taxed. Most significant was the transition from a worldwide to a quasi-territorial tax system. This was done by means of a deemed repatriation of accumulated post-1986 deferred foreign income, coupled with a full deduction for dividends paid from undistributed earnings by foreign corporations meeting certain ownership requirements.[2]

The TCJA did not implement a pure territorial system as it retained the rules under Subpart F for the taxation of certain categories of income earned outside the U.S. by foreign corporations, as well as created a new category of taxable income, global intangible low-taxed income ("GILTI"), that is intended to serve as a proxy of income earned from intangible property owned outside of the U.S.[3] A deduction is currently allowed for 50% of the GILTI inclusion.[4]

The TCJA's complement to GILTI is its favorable treatment of so-called foreign-derived intangible income ("FDII").[5] Unlike GILTI, which constitutes a new item of taxable income under the TCJA, FDII represents historically taxed income for which a partial deduction is now allowed. FDII, in theory, is foreign source income attributable to intangible property owned in the U.S. The TCJA presently allows for a 37.5% deduction from income characterized as FDII.[6]

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[2] I.R.C. §§ 965 & 245A.
[3] I.R.C. § 951A.
[4] I.R.C. § 250(a)(1)(B).
[5] I.R.C. § 250(b).
[6] I.R.C. § 250(a)(1)(A).

New limitations were placed on the deductibility of interest by the TCJA that materially affected numerous taxpayers. The TCJA amended IRC § 163(j) to limit the deduction for business interest expense to the sum of 30% of adjusted taxable income ("ATI"), plus business interest income and floor plan financing interest expense. For tax years beginning before January 1, 2022, ATI is similar to EBITDA. Disallowed interest expense deductions may be carried forward indefinitely until such time that sufficient ATI is recognized to allow for their deduction.

State conformity to federal depreciation has always been an issue since the enactment of bonus depreciation. TCJA amendments to IRC § 168(k) amplified the cost of state nonconformity by allowing for full expensing of qualifying purchases of property made after September 27, 2017, and before January 1, 2023.

Lastly, a matter affecting non-corporate taxpayers was the additional deduction allowed under IRC § 199A for 20% of their qualified business income ("QBI"). Intended to benefit small business owners, QBI, for purposes of the deduction, is business income earned by a sole proprietorship, partnership, S corporation, or trust, subject to numerous limitations that are beyond the scope of this article. As will be discussed, what is important for state income tax purposes is the fact that the QBI deduction is a deduction taken from adjusted gross income, and it is not an itemized deduction.

Methods of IRC. Conformity

As mentioned, nearly all states that impose an income tax begin their computation by reference to a taxpayer's federal taxable income. Having said this, how federal taxable income is adopted differs among the states. States that conform to the Internal Revenue Code (the Code) do so in one of three ways: (1) rolling conformity; (2) fixed date conformity; and (3) selective conformity.

A rolling conformity state will adopt the Code as currently in effect. As such, these states will automatically conform to changes to the Code without the need for additional action by the state legislature. A little over one-half of the states that impose an income tax do so using rolling/floating conformity. Rolling conformity states in the southeast include Alabama, Louisiana, and Tennessee.[7]

Fixed conformity states adopt the Code as enacted or in effect as of a specified date. While most of these states update their date of conformity on an annual basis, such updates to conformity do require legislative action. Georgia is a fixed conformity state. Other fixed conformity states in the southeast include Florida, Kentucky, North Carolina, South Carolina, and Virginia. At the time of passage of the TCJA, the eighteen states that operate as fixed conformity states did not conform to the changes. Currently, all but two now conform.

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[7] Note that Alabama does not conform to the Code for purposes of its individual income tax.

Selective conformity states are those that do not adopt federal taxable income as the starting point in the determination of state taxable income, but who will statutorily adopt federal income tax concepts or specific provisions of the Code. There are only two selective conformity states for corporate income tax purposes – Mississippi and Arkansas. Neither conforms to the TCJA.

As of the 2020 tax year, only four states do not generally conform to the TCJA. These include the two selective conformity states, Mississippi and Arkansas, as well as the two fixed conformity states that have not updated their date of conformity. California conforms to the 2015 version of the Code, and Texas conforms to the 2007 version of the Code. Having said this, advisors should be aware that there are some twists. For example, some of the fixed conformity states did not update their conformity until after 2017, the first year the TCJA took effect. Accordingly, states can conform in some years, but not all.

In addition to the date of conformity, another issue resulting from the TCJA is the question of what exactly the state conforms to? This was (and remains) important when evaluating state conformity to the QBI deduction for individuals and other non-corporate taxpayers. As mentioned, the deduction allowed by IRC § 199A is not taken into account when determining an individual's adjusted gross taxable income, nor does it qualify as an itemized deduction. The term "adjusted gross income" is defined by IRC § 62 to mean gross income, less certain enumerated deductions, of which QBI is not one. Similarly, the term "itemized deductions" is defined by IRC § 63(d) to mean deductions allowable under Chapter 1 other than, among other items, "any deduction provided in section 199A." This statutory analysis is supported by the presentation of Form 1040, where adjusted gross income is presented on line 8b, itemized deductions are shown on line 9, and the QBI deduction is taken on line 10.

The reason why the federal classification of QBI is important is because of the way most states define the starting point for determining an individual's state taxable income. Georgia, by way of example, defines an individual's Georgia taxable income to mean "the taxpayer's federal adjusted gross income[.]"[8] Georgia also allows individuals to claim itemized deductions; however, that deduction is allowed for "itemized nonbusiness deductions used in computing federal taxable income[.]"[9] Georgia is by no means unique in its adoption of adjusted gross income as the starting point in the determination of an individual's state taxable income, nor it is unique in allowing the individual to claim the itemized deductions that he/she claimed for federal income tax purposes. Because of this, however, the result is that the QBI deduction "falls through the cracks" in an overwhelming majority of states. An absent specific action by a state's legislature, the QBI deduction is available only in a small minority of states that define an individual's state taxable income by reference to that individual's federal "taxable income." In the southeast, only South Carolina conforms to "taxable income" for purposes of individual income tax; however, the state explicitly decouples from Section 199A of the Code.[10]

[8] O.C.G.A. § 48-7-27(a).
[9] O.C.G.A. § 48-7-27(a)(1).
[10] S.C. Code Ann. § 12-6-50(19).

While the state's general method and date of conformity to the Code are the necessary starting points in determining whether the state conforms to the TCJA, it is not the end of the analysis as states frequently decouple from sections of the Code; and it was not uncommon to see state legislatures opting not to conform to various provisions of the TCJA. The full expensing allowance under the TCJA's amendments to IRC § 168(k) is certainly the federal provision where the greatest amount of state decoupling occurred; however, that was largely already in place pre-TCJA as most states that decoupled from federal bonus depreciation did so by reference to Section 168(k) – thereby automatically extending the existing decoupling provision to full expensing.

TCJA changes to the taxation of foreign earnings and limitations on interest deductions were where most of the new state decoupling provisions were directed. Following the passage of the TCJA, many cynics believed states would likely conform to the revenue-raising provisions but would decouple from pro-taxpayer provisions. Indeed, that appeared to be the case with the taxation of foreign earnings where only three states explicitly decouple from GILTI, while nine states decouple from the deduction allowed for FDII. Further, some states went so far as to conform to the inclusion of GILTI, but decoupled from both the FDII deduction and the 50% deduction for GILTI provided by IRC § 250(a)(1)(B). These conclusions, however, need to be tempered by the fact that many states already allowed a deduction for foreign dividends, and that deduction may be applicable to GILTI. Much of the decoupling from IRC § 250 was done to prevent what the states perceived as a risk of double deductions, where taxpayers would take both the federal deduction, as well as a state allowed dividends received deduction for the gross amount of the foreign earnings.

The limitation imposed on interest deductions under Section 163(j) was another item where numerous states elected to decouple. Currently, for the 2020 tax year, six states, including Georgia, South Carolina, and Tennessee, in the southeast, allowing for the full deduction of interest that would otherwise be disallowed under the TCJA; and Virginia allows a taxpayer to deduct 20% of the disallowed interest.

Tax advisors should take note of the fact that states decouple from federal code sections generally in one of two manners, and the method of decoupling could have material tangential effects. A state will decouple from a federal code section by either (1) not adopting that code section when defining a taxpayer's federal taxable income, or (2) by requiring a modification to the taxpayer's federal taxable income. Georgia serves as a good example of why these different approaches to decoupling may lead to unexpected consequences.

Assume a corporation doing business in Georgia has a limitation on its interest expense deduction under IRC § 163(j) and, the corporation also recognizes GILTI. For purposes of this example, further, assume that the corporation would not have had an interest limitation under pre-TCJA 163(j) rules. As will be shown, Georgia will effectively decouple from both federal adjustments but will do so in different ways.

We begin with the statutory analysis. The Georgia income tax is imposed on a corporation's Georgia taxable net income. This income consists of "the corporation's taxable income as defined in the Internal Revenue Code of 1986, with the adjustments provided for in subsection (b) of [OCGA § 48-7-21]."[11] The Georgia Code defines the term "Internal Revenue Code of 1986" to mean the Internal Revenue Code as enacted on a specified date (depending upon the applicable tax year); however, "Section 163(j) . . . shall be treated as [it was] in effect before the 2017 enactment of federal Public Law 115-97[.]"[12] Accordingly, Georgia will require the taxpayer to compute its federal taxable income as though Section 163(j) was never amended by the TCJA.

With respect to GILTI, no adjustment is made in Georgia's definition of the Internal Revenue Code of 1986 with respect to IRC §§ 951A and 250; however, subparagraph (b)(8)(A) of OCGA § 48-7-21 allows for a deduction for dividends received from sources outside the U.S. That section explicitly provides that "[t]he deduction provided by Section 250 shall apply to the extent the same income was included in Georgia taxable income." The code section also provides that foreign dividends subtracted under this subparagraph shall be reduced by any expenses directly attributable to the dividend income. The Georgia General Assembly communicated its intent that GILTI would be treated as a dividend for purposes of the foreign dividend deduction. Accordingly, our hypothetical corporate taxpayer would deduct from its federal taxable income the amount of its GILTI inclusion that is net of the 50% deduction allowed by IRC § 250(a)(1)(B).

The net effect of both the above-described adjustments is that our hypothetical taxpayer recognizes neither the interest expense adjustment nor the GILTI inclusion for Georgia income tax purposes. Having said this, the taxpayer can be subject to additional adjustments because of the mechanics of each decoupling provision. With respect to the interest limitation, Georgia decouples from IRC § 163(j) by effectively striking it from the Code. Because the taxpayer's federal taxable income must be determined as though no interest adjustment had been made, other adjustments to federal taxable income (*i.e.,* limitations on charitable deductions) must be recomputed for Georgia purposes when determining the pro forma federal starting point.

With regard to the GILTI adjustment, Georgia's modification does not change the taxpayer's pro forma federal taxable income calculation. With that said, the Georgia modification does require an additional adjustment for expenses directly attributable to the GILTI.[13] Because the Georgia modification is applied after the 50% deduction allowed by IRC § 250, expense attribution is only required on the net amount of the GILTI that was actually subtracted under the Georgia statute.

This issue is not unique to Georgia. A review of state legislation providing for adjustments to the TCJA will reveal that some accomplish this by means of statutorily "striking" the relevant

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[11] O.C.G.A. § 48-7-21(a).
[12] O.C.G.A. § 48-1-2(14).
[13] As a practical matter, Georgia auditors have historically made assessments based the assumption that a percentage of the foreign dividend adjustment is representative of direct expenses – effectively resulting in a deduction that is less than 100% of the foreign dividend.

federal code section from that state's definition of federal taxable income, while others do so by means of statutory addition and subtraction modifications to the taxpayer's federal taxable income. Adjusting the definition of "federal taxable income" may have ripple effects in the overall determination of the taxpayer's federal starting point, while state modifications to federal taxable income may be subject to their own, unique limitations and adjustments.

Other State Issues Associated with the TCJA

While conformity was the primary question presented at the state level as a result of the TCJA, it was by no means the only uncertainty that has prompted responses by some states, but ongoing uncertainty in most. The TCJA has exacerbated historic state uncertainties concerning separate entity vs. consolidated reporting. The inclusion of large amounts of taxable income as a result of foreign earnings being deemed to be repatriated has raised questions of representation of a receipt in the apportionment factor. Uncertainties regarding what is and is not a dividend for purposes of state deductions for foreign dividends present themselves when considering GILTI and the mandatory repatriation under IRC § 965. Unique and disparate treatment of foreign source income raises questions of constitutionality of state conformity. These are but a few of the questions that remain largely unanswered.

Representation in the sales factor for the foreign earnings included in the tax base pursuant to IRC §§ 965 and 951A will almost certainly be a matter that will be litigated in the courts. While some taxing authorities have issued informal guidance on the topic, statutory and regulatory guidance is generally lacking. To the extent that factor representation is permitted, the question then becomes "How much representation is allowed?" Should the taxpayer include only the amount of income that is included in the base, or can the taxpayer include in its factor denominator the gross receipts that gave rise to the foreign earnings that are being taxed?

Factor representation is not the only apportionment issue presented by the TCJA and its taxation of foreign earnings. Some states have announced novel approaches to how such income should be apportioned. New Jersey, for example, originally proposed that GILTI be apportioned by reference to a gross domestic product ratio, but then subsequently retracted that position.[14] Maryland has indicated that GILTI should be included in the sales factor numerator based on the average of the U.S. shareholder's Maryland property and payroll ratios.

The differences that can result in consolidated vs. separate entity reporting stand out in the determination of the interest expense adjustment pursuant to IRC § 163(j). For federal reporting purposes, a taxpayer filing on a consolidated basis determines its interest limitation using the consolidated group's ATI and eliminating intercompany interest. Is it safe to assume that a separate entity reporting state will require a pro forma, separate company 163(j) analysis; and is it similarly safe to assume that a state that requires or permits combined or consolidated reporting will permit a consolidated calculation of the interest expense limitation? The answer, of course, is "No."

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[14] *See N.J. Technical Bulletin TB-85(R)* (Aug. 22, 2019).

Tennessee and Pennsylvania, two separate entity reporting states, both announced that a corporation filing as part of a consolidated group for federal tax purposes would only calculate a state expense limitation if the consolidated group had a limitation federally.[15] Conversely, Massachusetts, a combined reporting state, issued a Technical Information Release (TIR 19-17) announcing that the limitation must be calculated on a separate entity basis.

Probably one of the most material questions that will almost certainly need to be settled in many state courts will be whether GILTI and, perhaps, the earnings repatriation pursuant to IRC § 965 qualify as dividends for purposes of state deductions afforded foreign dividends. Pursuant to the Commerce Clause of the U.S. Constitution, states are prohibited from discriminating against foreign commerce. The U.S. Supreme Court has held that a state cannot provide more favorable treatment for domestic dividends than it does for foreign dividends.[16] As a result, most states that conform to the federal deduction for dividends allow for a similar deduction for foreign dividends.

The question arises as to whether GILTI and, to a lesser extent, Section 965 repatriation qualify as dividends due largely to the absence of actual distribution. While some state legislatures and taxing authorities have announced that GILTI would be treated as a dividend, most are silent, and a few have explicitly announced their intent to treat it as something other than a dividend. For example, on December 10, 2019, Nebraska issued a General Information Letter announcing that GILTI was not eligible for the state's foreign dividends received deduction on the basis that it was not a dividend.[17]

To the extent GILTI and/or the Section 965 repatriation are found to be taxable, questions will be raised as to whether a state's taxation of such deemed income constitutes an unconstitutional discrimination against foreign commerce due to the fact that no similar imputation of income exists for stock ownership of domestic subsidiaries. Again, this is a question that most certainly will need to be resolved by the courts – perhaps the U.S. Supreme Court.

In conclusion, we've come a long way since Congress' passage of the TCJA. At the time it was signed into law, less than half of the states conformed to its broad changes. Since that time, we are down to only four states that impose some form of an income-based tax and who do not conform, at least generally, to the federal reform provisions. While that is the case, selective nonconformity to specific provisions is not uncommon, and questions remain as to how historic state tax laws dealing with such concepts as apportionment, separate vs. consolidated reporting, and modifications to federal taxable income apply to provisions in the TCJA. While some of these uncertainties will be resolved legislatively, and through administrative action, many will almost certainly require the intervention of the courts. The key thing, however, is that

[15] Note that Tennessee no longer conforms to I.R.C. § 163(j) beginning in 2020.
[16] *Kraft v. Iowa,* 505 U.S. 71 (1992).
[17] Neb. Dep't of Rev. GIL 24-19-3 (Dec. 10, 2019).

tax advisors must remain vigilant, and not simply assume that the mere fact a state adopts federal taxable income as its starting point solves all problems.