State tax implications of federal tax reform: FAQ

February 14, 2017

kpmg.com

State Tax Implications of Federal Tax Reform: FAQ

One of the (many) surprising outcomes of the November election is that comprehensive federal tax reform in the near future became a real possibility. With President Trump in the White House and Republicans holding a majority in both the House and the Senate in the 115th Congress, the prospects for significant tax legislation being enacted in 2017 or 2018 have increased substantially. While there are still many unknowns, details are still evolving, and enactment is not certain, major tax reform proposals were outlined by President Trump in his campaign and were proposed by House Republicans in last June's tax reform "Blueprint."[1] Differences exist between the President's campaign proposals and the Blueprint, but both envision broadening the base and reducing individual and corporate income tax rates. They also propose other substantial changes to the taxation of business income, with the Blueprint recommending to move the corporate income tax toward a destination-based cash flow tax. While much attention and debate has been focused on the substantive provisions and ramifications of the proposals at the federal level, it is important to remember that, if enacted, any federal reform would have both direct and indirect impacts on states and their income tax structures. This FAQ document outlines why and how federal reforms could generally affect states and discusses the state tax implications of specific components of the two plans. The document is organized as follows:

1. What is the tie-in between state and federal taxes, and why would federal reform affect state taxes?
2. Would federal reform create timing issues for states?
3. What are the state tax implications of key aspects of President Trump's campaign proposals and the House Republican Blueprint?
   a. Corporate rate reductions
   b. Expensing certain assets
   c. Disallowing the deduction of certain interest expenses
   d. Modifications of net operating loss (NOL) deductions
   e. Border adjustment
   f. Move to a territorial tax system and repatriation of deferred foreign earnings
   g. Repeal of "special interest" tax preferences

---

[1] Descriptions of the components of the various plans have been largely pulled from the following sources: KPMG's *Understanding the Tax Reform Process: FAQs* (Dec. 5, 2016), which can be accessed here and *KPMG Report: Comparison of Republican House "Blueprint" and Trump's tax proposals* (Nov. 14, 2016) which can be accessed here. For the full Blueprint report, see *A Better Way: Our Vision for a Confident America: Tax* (June 24, 2016), *available at* http://abetterway.speaker.gov/?page=tax-reform.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

    h. Taxation of pass-through entities
    i. Individual income tax changes
    j. Estate and gift tax
4. What would be the revenue effects of the federal reform proposals at the state level?
5. How does this square with state balanced budget requirements?
6. What would happen if the states did not conform or delayed their conformity?

1. What is the tie-in between state and federal taxes, and why would federal reform affect state taxes?

Nearly every state conforms its state corporate and personal income tax in some manner to the corresponding federal tax. In large part, states begin the computation of state corporate taxable income with federal taxable income and therefore allow, for state tax purposes, many federal deductions.[2] States do not, for the most part, conform to various federal tax credits aimed at promoting one type of activity or another, such as credits for alternative energy sources.[3] Each state requires taxpayers to make several modifications (both additions and subtractions) to federal taxable income to arrive at state taxable income. The corporate income tax modifications may be driven by constitutional considerations or may simply be areas where the state has declined for policy or fiscal reasons to follow federal law.

For example, many states decouple from federal deductions that decrease federal taxable income, such as bonus depreciation and the Domestic Production Activities Deduction allowed under Internal Revenue Code (IRC) section 199. If tax reform affects the computation of federal taxable income, which it almost certainly would (if enacted), then that would directly affect the computation of state taxable income.

---

[2] A majority of the states start with Line 28 of federal Form 1120 (taxable income before net operating losses and special deductions), and the remainder start with Line 30 which includes net operating losses and special deductions. *See* Healy and Schadewald, *2016 Multistate Corporate Tax Guide*, Vol. I, Part 3.

[3] The research and development credit is one exception here, as a number of states allow a counterpart credit based largely on the contours of the federal credit.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

As with the corporate tax, states conform their personal income taxes in many regards to the federal personal income tax. Most states conform to the federal definition of adjusted gross income (AGI), but some (seven) conform to federal taxable income (meaning they incorporate the federal standard deduction and personal exemption allowance in addition to the AGI provisions).[4] States that allow itemized deductions also generally conform to the federal itemized deductions, with the most common model allowing all federal itemized deductions other than the deduction for state income taxes.[5] As with the corporate tax, states tend not to conform to a wide range of income tax credits. The credit for dependent and child care expenses and the earned income credit are the most common exceptions to this general rule. In addition, only a few states have an individual alternative minimum tax (AMT).[6] Thus, federal tax reform changes that alter the computation of AGI and itemized deductions would have an impact on most state personal income taxes, presuming states maintain their current degree of conformity with the federal tax.

2. Would federal reform create timing issues for the states?[7]

Enactment of significant federal tax reform could potentially create some significant timing issues for a number of states, depending on when the federal changes are enacted and when they are made effective. States conform to the federal tax code in one of two ways. Many states, often called "static conformity" or "fixed date" states, conform to the federal tax code as of a certain date.

For example, if a state conforms to the IRC as of January 1, 2014, the state does not adopt federal tax changes enacted after that date. The "fixed date" conformity states for corporate income tax purposes are Arizona, California, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, New Hampshire, North Carolina, Oregon, South Carolina, Texas, Virginia, West Virginia, and Wisconsin.[8]

---

[4] *See* Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points,* available at http://www.taxadmin.org/assets/docs/Research/Rates/stg_pts.pdf, for a display of current conformity for individual tax purposes.

[5] Rick Olin & Sandy Swain, *Individual Income Tax Provisions in the States, Informational Paper No. 4,* Wisconsin Legislative Fiscal Bureau, p.6. (Jan. 2015).

[6] *Id.* See individual state summaries therein.

[7] By timing issue, we are referring to actual timing issues, not book/tax timing differences.

[8] *See* RIA All States Tax Guide, *Federal Income Tax Rules Used in the States, available at* http://www.checkpoint.thomsonreuters.com/. California is listed as a "fixed-date" state for purposes of this document, but it is important to note that California does not adopt the IRC as a whole. Rather, the state adopts selective provisions of the IRC as of a fixed date.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

The fixed date or static conformity states, as a general matter, update their conformity to the IRC each year or at least with some regularity, but a few (notably California) rarely update their conformity and are quite selective with the provisions to which they conform. Most of the remaining states are what are termed “moving” or “rolling conformity” states; they adopt the federal tax code as currently in effect for the tax year in question. In these states, federal law changes are automatically incorporated into the state code unless and until the state specifically decouples from the federal provisions.

One of the key issues facing states is when federal tax reform might occur and be effective. Most state legislatures will convene in early 2017 and will adjourn by midyear. There are certain states that have particularly short sessions, such as Florida (March 7, 2017 to May 5, 2017) and Virginia (January 11, 2017 to February 25, 2017). It is entirely likely that, even if federal tax reform is enacted in 2017 (which is far from certain), it would not be accomplished by the time state legislatures adjourn. This means that, unless a special session is called, certain states would not be able to address any federal reform until 2018. Depending on the effective date of federal tax law changes, this could lead to a significant disconnect between federal and state tax laws, particularly in static conformity states. When preparing state returns, taxpayers in such states may find themselves having to calculate the federal taxable base at least twice, once under a reformed federal code and again under the version of the IRC still effective in the state.

In contrast, states that adopt the IRC on a rolling basis would automatically adopt the federal changes unless they enacted legislation to decouple. Again, depending on the timing and effective dates, the legislatures in certain states may be out of session when federal reform is enacted and may be unable to react before the changes become effective. These states may find themselves confronted with a tax structure that potentially disrupts their fiscal plans and budgets with little or no time to react or take any countervailing measures.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

3. What are the state tax implications of key aspects of President Trump's campaign proposals and the House Republican Blueprint?

a. Corporate rate reductions

Both the Blueprint and President Trump's campaign proposals aim to reduce corporate income tax rates. Viewed in isolation, federal corporate income tax rate reductions would not directly affect the states because state corporate income taxes are not computed as a percentage of federal tax liability.[9] Rather, as discussed above, states generally start the computation of state taxable income with federal taxable income. Thus, federal tax base changes would directly affect the states. However, if the federal corporate income tax rate drops to 15 percent (Trump campaign proposals) or 20 percent (House Blueprint), then state corporate income taxes could suddenly become a much more significant part of a company's overall effective tax rate. This may cause some corporate taxpayers to shift more attention to their now-comparatively-larger state income tax burden. It may also increase attention to the availability of various state-level incentives available for locating economic activity within a particular state.

b. Expensing of certain assets

A key component of both President Trump's campaign proposals and the House Blueprint is to reduce the after-tax cost of business investment by allowing the acquisition of certain assets to be immediately expensed instead of depreciated over time. The President's campaign proposal would allow some manufacturers to choose to expense capital investment in return for forgoing corporate interest expense deductions. The Blueprint proposes to allow all business taxpayers to fully and immediately expense the cost of investments in tangible property (e.g., equipment and buildings) and intangible assets, but not land.[10]

---

[9] There may be an impact in the few states that allow corporate taxpayers a deduction for federal taxes paid.

[10] The Blueprint also places limits on the deductibility of certain corporate interest expenses. The impact of these limits on state taxes is discussed later.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

Given that any new expensing deduction would occur in the course of computing federal taxable income, a state's corporate income tax would conform to the federal expensing provisions, unless the state chose to decouple or chose not to update its conformity date to incorporate the IRC in effect for the period that includes tax reform. In the recent past, states have shown a widespread propensity for not conforming to federal efforts to stimulate investment by accelerating depreciation deductions through the use of "bonus" first-year depreciation. Failure to adopt these federal provisions is often because of the negative revenue impact of such measures and state balanced budget requirements. Under current federal law, taxpayers are allowed a 50 percent bonus depreciation deduction for qualified property acquired after December 31, 2007 and placed in service prior to January 1, 2018. In addition, certain business taxpayers are allowed to fully expense limited amounts of assets placed in service during the tax year under IRC section 179. The amount of assets that can be expensed under section 179 was increased substantially in 2010. As of 2015, about two-thirds of the states with a corporate income tax did not conform to the 50 percent bonus depreciation,[11] and at least 10 states did not incorporate the expanded section 179 provisions adopted in 2010.[12]

Any decoupling from federal provisions creates complexity for business taxpayers. These taxpayers would need to track separate state rules and guidance, maintain separate state records for the particular provision, incorporate the differences into the state tax return, and make any necessary basis adjustments upon disposition of affected assets. If the federal government moves to a system of complete expensing, states would need to maintain a capital cost recovery system using depreciation without the corresponding federal infrastructure of depreciation schedules, rules and guidance, audits, and controversy resolution process.[13] In such a situation, the degree of complexity and uncertainty regarding state rules would seemingly increase over time, and the pressure on states to conform would likely also grow.

---

[11] See Healy and Schadewald, *2016 Multistate Corporate Tax Guide,* Vol. I, Part 3.

[12] See Healy and Schadewald, *2016 Multistate Corporate Tax Guide,* Vol. I, Part 3.

[13] It should be noted that for corporate franchise (income) tax purposes, California does not adopt IRC section 168 (MACRS or ACRS for depreciating property); rather, the state adopts its own depreciation methodology.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

One consideration in assessing the impact of the expensing provision on states from a revenue perspective is that conforming to a system as proposed in the Blueprint would have a relatively greater fiscal impact on states than it would on the federal government because of the degree to which states have decoupled from the 50 percent bonus depreciation. That is, the incremental deduction allowed a taxpayer at the federal level for expensing a new asset is only 50 percent of the asset cost, whereas the incremental deduction on the state level is the full cost of the asset less any first-year depreciation that would be allowed under state law (which varies depending on the manner in which the state chose to decouple from bonus depreciation). [14]

c. Disallowing the deduction of certain interest expenses

Under the House Blueprint, businesses would be able to deduct interest expense only to the extent it is netted against interest income, with any net interest expense beyond that being carried forward indefinitely. States generally conform to IRC section 163, which addresses the deduction for interest expenses. So, to the extent the limitations on the deductibility of interest were incorporated into section 163, they would be adopted by rolling conformity states or states that updated their fixed-date conformity to capture the IRC in effect for the period that includes tax reform (unless such states chose to decouple).[15] President Trump's campaign proposal would disallow the deduction of interest expenses only for those taxpayers that choose to expense asset purchases, an option available for some manufacturers under his plan.

---

[14] The potential magnitude of this revenue impact is a bit difficult to discern. The Joint Committee on Taxation ("JCT") provides the official revenue score of tax legislation for Congress, but has not yet released official revenue estimates of the Blueprint or President Trump's campaign proposals. However, some outside groups have done their own revenue estimates. These estimates use different models and make various assumptions about technical details of the proposals; these estimates will undoubtedly differ from the estimates JCT ultimately provides. The Urban Institute-Brookings Tax Policy Center estimates of the President's campaign proposal and the Blueprint combine the effects of expensing and the limits on the deductibility of interest (discussed separately here). Both the Tax Policy Center and the Tax Foundation estimate the combined revenue loss at the federal level under the Blueprint to total over $1 trillion in the first ten years from 2016-2025 (on a conventional basis, i.e., without factoring in any dynamic macroeconomic effects from the overall reform). See Jim Nunns, et al., *An Analysis of the House GOP Tax Plan,* Tax Policy Center (Sept. 16, 2016); Kyle Pomerlau, *Details and Analysis of the 2016 House Republican Tax Reform Plan,* Tax Foundation Fiscal Fact No. 516 (July 2016). Interestingly, about 60 percent of the effects of the expensing change show up as a change in individual income taxes due to pass-through entities.

[15] Special rules may be developed for financial institutions where interest expenses and earnings are a part of the business model.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

What is more interesting, however, is how these federal limits would coexist with limits on the deductibility of interest that are currently applied in a number of states, notably states that require each corporation to file a separate return. Certain separate return states employ "addback" or "expense disallowance" statutes to disallow deductions for interest paid to related parties, unless certain exceptions are met.[16] One question that arises is whether the federal limits on the deductibility of interest would be applied at the consolidated group level or on an entity-by-entity basis. To the extent states continued to apply their current expense disallowance rules and adopted the federal limits, there are a number of ancillary issues that could arise. For example, would the state interest addback apply to the federal interest expense prior to or after netting against interest income? Would exceptions to the interest addback provisions apply before or after netting? The interest disallowance proposed under the reform plans are broader than existing state disallowance provisions in that they would apply to all interest expense, regardless of the payee, in excess of the amount of interest income, likely because at least part of the impetus for the provision is to provide parity between debt and equity financing of investment, regardless of the parties involved.

d. Modifications to net operating loss (NOL) deductions

The House Blueprint would allow net operating losses (NOLs) to be carried forward indefinitely and to be increased by an interest factor that compensates for inflation and a real return on capital. However, NOLs would not be allowed to be carried back, and the deduction with respect to NOL carryforwards would be limited to 90 percent of the net taxable income for the year determined without regard to the carryforward.

This change would appear to have a limited application in many states as a number of them do not conform to the federal NOL deduction itself. Rather, these states either start the computation of state taxable income (1) with line 28 of the federal form 1120, which is federal taxable income before NOLs and special deductions and then require the taxpayer to compute a state-specific NOL; or (2) with line 30 (which includes NOLs and special deductions), but then require taxpayers to add back the federal NOL and compute a state-specific NOL.

---

[16] See Healy and Schadewald, *2016 Multistate Corporate Tax Guide,* Vol. I, Part 3. Presumably, in a combined reporting regime, the disallowance would operate such that the elimination of transactions among the members of the unitary group prior to the computation of group income would result in only the net interest expense of the group being disallowed.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

Under current federal law, a taxpayer generally can carry back a NOL for two years and carry it forward for twenty years. Adoption of the Blueprint approach at the federal level would actually move the federal NOL deduction closer to the general, current state NOL practice. In large part because of the revenue implications, there are only about a dozen states that currently allow the carryback of a NOL to a prior tax year, and in some cases, the amount of NOL allowed to be carried back or refunded is limited. Although many states require computation of a state-specific NOL, all states generally allow NOLs to be carried forward for some period, but not always the twenty years allowed under the IRC. Some states—notably Louisiana and Connecticut—currently limit use of NOL carryforwards to a percentage of net income.[17] Because the computation of state NOLs deviates from federal practice, tracking state NOLs will likely continue to be difficult.

With the current state limits on the use of NOLs, particularly the carryback of NOLs, the revenue impact of conforming to the proposed federal treatment would have a smaller relative impact in most states than at the federal level. Given the number of differences between state and federal treatment of NOLs under current law, state conformity to federal NOL reform would likely require state legislation adopting the new federal model in most states.

e. Border adjustment

The House Blueprint proposes to move the U.S. from a net income tax system toward a destination-based cash-flow tax, or a form of consumption tax that allows deductions from gross receipts only for the costs of goods and services purchased from other firms and for labor. This concept is not unheard of in the state tax world.[18] The House Blueprint proposal is also intended to move the U.S. to a territorial tax system where the tax base is limited to domestic consumption (or income from consumption sourced to the U.S.) and away from the current system of taxing individuals and business on their worldwide income.

---

[17] Healy and Schadewald, *2016 Multistate Corporate Tax Guide*, Vol. I, Part 3.

[18] The now-repealed Michigan Business Tax's Gross Receipts Tax component was based on gross receipts with a deduction for purchases from other firms.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

A key part of that move as proposed in the Blueprint is to include a "border adjustment" in the cash flow tax that would exempt exports from tax and impose tax on imports.[19] The border adjustment would most likely be implemented by excluding receipts from sales involving the export of products, services, and intangibles from the base of the federal tax and by disallowing the deduction of costs incurred in the acquisition of imports from the base, instead of an actual tax being imposed on imports.[20]

Under this exclusion/ disallowance model, the impacts would be reflected in the tax base of those states that conform to the proposed federal cash flow tax provisions. A state that retains conformity to the pre-reform IRC would not experience the effects of these provisions. The border adjustment is expected to be one of the main revenue-raising provisions in the Blueprint (along with net interest expense disallowance) used to offset the revenue impact of the reduced federal tax rate, expensing of assets and certain other provisions. Both the Tax Policy Center and the Tax Foundation estimate the border adjustment provision would increase federal receipts, absent any other change, by about $1 trillion over ten years.[21] Incorporation of the border adjustment into the state tax base would appear to have a significant effect on whether states would adopt rate changes in response to the federal reform.

---

[19] The purpose of a border adjustment is to neutralize the influence of tax in the decision of whether to purchase an item from a domestic supplier or to import it. The border adjustment proposal has drawn considerable attention regarding its possible impact on trade and those sectors that rely heavily on imported goods as part of the supply chain. For a discussion of the potential trade and economic impacts of a border adjustment process, see, for example, Alan J. Auerbach and Douglas Holtz-Eakin, *The Role of Border Adjustments in International Taxation,* American Action Forum (Nov. 28, 2016), *available at* https://www.americanactionforum.org/research14344/; David A. Weisbach, *A Guide to the GOP Tax Plan – The Way to a Better Way,* Coase-Sandor Institute for Law and Economics Working Paper No. 788 (Jan. 2017); Martin A. Sullivan, *Economic Analysis: Unlike VAT, Cash Flow Tax Helps Exports, Hits Imports,* Tax Notes (Jan. 9, 2016); Martin A. Sullivan, *Economic Analysis: Cash Flow Tax and Trade: Small Effects Likely,* Tax Notes (Jan. 17, 2016); Informix, *Macroeconomic Impact Analysis of the Business Provisions of the House GOP Blueprint for Tax Reform, Final Report,* Interindustry Forecasting at the University of Maryland (Jan. 10, 2017).

[20] Border adjustments are commonly used in a value added tax or indirect tax setting. No country applies the border adjustment concept to a direct tax, i.e., an income tax. The World Trade Organization (WTO), the governing body for the General Agreement on Trade and Tariffs, in fact, allows border adjustments for "indirect taxes" because they are seen as being applied to the product, neutral with respect to the choice between domestic goods and services and imports and not viewed as an export subsidy. The cash-flow tax allows a deduction for wages (as well as input purchases) and retains some other features of the current federal income tax. For these and other reasons, there are questions as to whether the border adjustment as proposed would meet the requirements of the WTO. For a discussion, *see* Weisbach*, op cit.,* pp. 38 – 44.

[21] See Jim Nunns, *et al., An Analysis of the House GOP Tax Plan,* Tax Policy Center (Sept. 16, 2016); Kyle Pomerlau, *Details and Analysis of the 2016 House Republican Tax Reform Plan,* Tax Foundation Fiscal Fact No. 516 (July 2016).

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

f. Move to a territorial system of taxation and repatriation of deferred foreign earnings

The Blueprint proposes to move the U.S. international tax system from one in which an individual or company is taxed on its worldwide income (with taxation deferred until the income is repatriated to the U.S.) to a territorial system that taxes U.S.-based or U.S.-sourced earnings. To accomplish this, the Blueprint proposes to provide a 100 percent exemption for dividends received by a U.S. entity from a foreign subsidiary. It also proposes to repeal most of the current "subpart F" regime that subjects certain income of controlled foreign corporations (CFCs) to current taxation.[22] As a transitional move, the Blueprint would impose an 8.75 percent tax on existing accumulated foreign earnings held in cash or cash equivalents and a 3.5 percent tax on all other accumulated foreign earnings (with companies able to pay the tax on repatriated earnings over an eight-year period).

President Trump proposed in his campaign to tax the earnings of CFCs on a current basis at 15 percent and to tax accumulated earnings held offshore under a one-time deemed repatriation at a 10 percent rate.

The impact of these proposals on state business taxes would depend on several factors including the manner in which they would be implemented at the federal level, state conformity to the federal base, current state treatment of income from foreign entities, and other provisions of state law. There would likely also be constitutional considerations to address.[23] The American Jobs Creation Act of 2004 contained a similar one-time reduced rate on certain repatriated earnings.[24] The reduced tax rate of 5.25 percent was accomplished by providing an 85 percent dividends received deduction for qualified repatriations. If implemented in a similar fashion, the amounts deemed to be repatriated less the dividends received deduction would flow into the state tax base of those states that start the computation of state taxable income with Line 30 of the federal form 1120.

Other factors that would affect the ultimate taxation of the repatriated amounts, if likewise accomplished through a dividends received deduction, rather than a stand-alone calculation, would include:

---

[22] The Blueprint suggests that foreign personal holding company rules governing the taxation of foreign passive income would remain in place.

[23] The treatment of foreign dividends and other parts of the reform dealing with the taxation of foreign income will require an examination of the Supreme Court decision in *Kraft General Foods v. Iowa Department of Revenue,* 505 U.S. 71 (1992) holding that differential treatment of certain foreign dividends compared to domestic dividends violated the Commerce clause. With potential relevance to the issue at hand, the Court also said "The adoption of the federal system in whole or in part, however, cannot shield a state tax statute from Commerce Clause scrutiny." *Id.* at 82.

[24] American Jobs Creation Act of 2004 (P.L. 108-357), § 422; Codified as IRC § 965.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

— Does the payee corporation have nexus with the state?

— How does the new provision interact with state statutes allowing deductions for dividends received from domestic and foreign entities?

— Are some or all of the dividends eliminated as intercompany transactions in certain combined reporting states?

— In states that utilize property and payroll factors in their apportionment formula, would the factors of the payor be utilized for apportionment purposes, presuming the dividends are considered apportionable business income?

With respect to the other components of the Blueprint that would move the federal tax to a "territorial system" (i.e., dividends received deductions and repeal of Subpart F rules), the impact on the states would be largely dependent on the degree to which they currently include or exclude foreign earnings in the tax base. To a considerable extent, states exclude foreign earnings from the state tax base through dividends received deductions or other modifications that remove such earnings from the states' federal starting point.[25] There are exceptions, however. In particular, the interaction between the territorial system at the federal level and the system in those states that allow or require (in certain instances) worldwide combined reporting could be complicated.

g. Repeal "special interest" tax preferences

President Trump's campaign proposals called for the elimination of "most" business tax expenditures, but provided no specifics regarding which would be eliminated, other than that the research credit would be retained. Similarly, the Blueprint calls for the repeal of many "special interest deductions and credits" that are designed to encourage particular business activities. The Blueprint references the IRC section 199 Domestic Production Activities Deduction as an example of one such preference, but references the research credit as a desirable feature. As a result of the lack of specificity, it is difficult to speak definitively to the impact on state taxes.

---

[25] Healy and Schadewald, *2016 Multistate Corporate Tax Guide,* Vol. I, Part 7.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

As a general matter, however, the repeal of federal tax credits would be expected to have limited impact on states as they do not commonly conform to or piggy-back on federal credits, although there are exceptions. For example, certain states have a research credit that is modeled after or expressed as a percentage of the federal credit. Thus, the repeal of most federal tax credits seems unlikely to have a significant impact on state taxes. If there was a federal repeal of a credit that was picked up by a state, the state would need to take some action to preserve the credit.

h. Taxation of pass-through entities

The Blueprint proposes to cap the tax rate paid on “active business income” earned by sole proprietorships and pass-through entities at a maximum rate of 25 percent rather than the personal income tax rate attributable to the recipient of the income. A sole proprietor or “owner-operator” of a pass-through, however, would have to pay, or would be treated as having been paid, “reasonable compensation.” The “reasonable compensation” would be subject to the normal individual rates. It is not clear how “reasonable compensation” would be defined for this purpose.

With a few exceptions, states currently tax pass-through and sole proprietorship income at the normal individual income tax rates, or in some cases, at the entity-level. Kansas is an exception in this regard, in that it currently excludes business income from certain pass-through entities from taxation at the individual level. In assessing whether to correspondingly adopt a special rate for pass-through income, states would likely consider the differential between their corporate rate and the individual tax rates and whether that differential was sufficiently large to influence the choice of corporate form by taxpayers or to result in substantially differential taxation of business and personal income.

i. Individual income tax changes

Both President Trump’s campaign proposals and the Blueprint also propose substantial reform of the personal income tax, with both taking a general approach of broadening the tax base by repealing various deductions, exclusions, and other preferences, and reducing tax rates to offset the broader base. Specifically, the President, in his campaign, proposed implementing a three-bracket tax rate structure of 12/25/33 percent; increasing the standard deduction; repealing the personal exemption allowance; capping itemized deductions at $100,000 for individual and $200,000 for joint filers; increasing benefits for dependent care and child care; taxing carried interest as ordinary income; repealing the Alternative Minimum Tax (AMT); repealing the net investment income tax; and retaining the maximum tax rate on capital gains of twenty percent.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

The Blueprint proposes to adopt a similar three-rate structure; consolidate the standard deduction and personal exemption into a larger standard deduction; eliminate itemized deductions except for charitable deductions and home mortgage interest; enhance the child and dependent care credit; repeal the tax on net investment income and the AMT; and adopt a 50 percent exclusion for the taxation of capital gains, interest, and dividends.

Given the degree of conformity to current federal provisions and the complexity that the large body of individual taxpayers would face if the states did not conform to federal changes, it is not unreasonable to expect that states would conform their personal income tax regimes to many of the proposed federal changes if those changes are enacted. One caveat to this generality is that while states generally allow a standard deduction and personal exemption allowance, most states do not adopt the federal amounts for these features.[26] As a result, it may be that states would not accept proposals made by the Trump campaign and the Blueprint to repeal personal exemption allowances and reflect the change (at least partially) in a larger standard deduction and accommodate differences in household size through an enhanced child and dependent care credit.

The extent to which states would be likely to reduce rates to reflect any base broadening changes is unknown. Decisions to reduce rates likely would be dependent on the impact of the proposed federal changes in each individual state, the overall fiscal conditions and tax structure in each state, and other factors such as the distributional effects of the changes. Estimates from both the Tax Foundation and the Tax Policy Center indicate that the net effect of the individual income tax changes of the Trump campaign proposals and the Blueprint when measured on a conventional basis (not considering macroeconomic effects the reform may have on economic growth) would be a reduction in federal revenues of about $1 trillion to $2 trillion over a ten-year period extending from 2016 to 2025.[27]

Given state balanced-budget requirements, it should not be expected that states will reduce rates to the extent that the President’s campaign plan and the Blueprint have proposed. The degree to which states might be able to reduce rates would likely be largely dependent on whether they conform to the proposals to cap or eliminate most itemized deductions and eliminate personal exemption allowances, as those are the features that have the largest base-broadening impact at the federal level.[28]

---

[26] It should not be expected that the nine states that do not allow itemized deductions would adopt an itemized deduction scheme along the lines proposed in the two plans.

[27] *See* Nunns *et al., op. cit.,* p. 9, and Pomerlau, *op. cit.,* p. 5.

[28] Nunns *et al., op. cit.,* p. 9. The Tax Policy Center analysis estimates that eliminating all itemized deductions except charitable contributions and mortgage interest along with repealing the personal exemption allowance will increase federal receipts by

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

One clear effect the Blueprint would have on states and localities is that the proposed repeal of the itemized deduction for state and local taxes paid would increase the "after tax" cost of state and local services.[29] The increase in the effective rate for state and local taxes is likely to increase interest in restraining the size of the state and local sector or in seeking state and local tax rate reductions and tax cuts. The ability to accommodate such pressures likely would be tempered by state and local public service requirements, current fiscal conditions, & balanced budget requirements.[30]

j. Estate and gift tax

The Blueprint proposes to repeal the federal estate, gift and generation-skipping transfer taxes, and the President also proposed the repeal of these taxes in his campaign, with a provision that would tax capital gains on assets held until death with an exemption of $10 million for married couples and $5 million for single individuals.

State estate taxes have undergone substantial changes since the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Prior to 2001, every state levied either an estate or inheritance tax in the form of a "pick-up tax" designed to at least absorb the state estate tax credit allowed under the federal estate tax. EGTRRA phased out the state estate tax credit over four years, meaning that any state estate tax that remained was actually a tax on the estate, as opposed to an offset to federal estate taxes that would otherwise be collected. As a result of EGTRRA, 32 states have repealed their state estate taxes, and 18 states and D.C. continue to levy a state estate tax. The rates and exemptions for state estate taxes are set independently of the federal tax, but the structure and base of the tax are modeled after the federal tax.[31] If the federal estate tax regime is repealed entirely, states would be required to maintain that infrastructure independently or tie the state estate tax to a particular date when the federal tax was in existence.

---

about $3.6 trillion over 10 year, an increase which is then largely offset by reducing federal rates and increasing the standard deduction. *Id.*

[29] The same is true, but to a lesser extent, of the campaign proposal to cap itemized deductions. The cap acts somewhat like the current individual AMT, while the repeal of deductibility proposed in the Blueprint would have a more significant impact.

[30] The issue of deductibility is "top of mind" for many state officials as they generally call for the deduction for state and local taxes to be maintained. See, for example, policy statements on federal tax reform from the National Governors Association and the National Conference of State Legislatures. National *Governors Association, Governors' Recommendations for President Trump: Tax Reform,* https://resources.nga.org/cms/wethestates/taxreform.html (last visited Feb. 7, 2017); National Conference of State Legislatures, *Letter to Reps. Charles Boustany and Richard Neal RE Hearing on Fundamental Tax Reform Proposals* (Apr. 14, 2016), available at http://www.ncsl.org/documents/statefed/Tax_Policy_Letter_041416.pdf.

[31] For a discussion of state estate taxes, see Roxanne Bland, *Whither the Estate Tax?,* State Tax Notes (February 6, 2017).

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

4. What would be the revenue effects of the proposed reforms at the state level?

A primary aim of a number of the provisions in both the President's campaign proposals and the Blueprint is to broaden the federal tax base (both personal and corporate) and thereby allow substantial reductions in individual and corporate marginal tax rates. Both proposals contain an individual rate structure that has three brackets with marginal rates of 12/25/33 percent (compared to a maximum marginal rate of 39.6 percent under current law). At the corporate level, the President in his campaign proposed a flat rate tax of 15 percent while the Blueprint proposes a single rate of 20 percent. A frequently asked question (pun intended) is should similar tax rate reductions be expected at the state level given the various linkages between state and federal taxes?

There is, of course, no singular or easy answer to this question. How states respond to a potentially broader tax base likely would depend on a number of factors that are individual to each state. Among others, some of the factors expected to affect a state's decision are the fiscal condition of the state; the degree to which the state tax base is actually broadened given the different linkages between the state and federal taxes and the potential for states to decouple from certain federal provisions; the distributional impact of any potential rate changes in light of the broader tax base; and the political culture and tax philosophy of the state legislative and executive branches.

Several factors to keep in mind in considering the potential for state tax rate reductions as a result of federal reform include:

— State balanced budget requirements could constrain the ability of a state to substantially reduce overall corporate and individual tax revenues in response to federal tax reform. Congressional discussions of tax reform have proceeded from an expectation that the overall reform will be revenue neutral and that the estimated revenue effects of the reform will be determined using a "dynamic" modeling approach intended to capture the effects of the reform on economic growth and thus federal revenues. There likely would be uncertainty as to how the macroeconomic effects of a federal reform would affect individual states, which may lead to some reluctance on the part of states to incorporate the full dynamic effect into state estimates.[32]

---

[32] The dynamic scoring effects can be substantial. The Tax Foundation estimates that on a conventional basis (termed "static" by the Foundation), the Blueprint would reduce federal revenues by $2.4 trillion over the first 10 years, but on a "dynamic" estimating basis, the net effect would be to reduce federal revenues by only $191 billion over that period. See Pomerlau, *op. cit.,* p. 5. The Tax Policy Center "dynamic" estimates show a lesser effect, reducing a loss under conventional estimates of $3.1 trillion over 10 years to about $2.5 trillion. *See* Nunns *op. cit.,* p. 9.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

— State tax rate reductions (both corporate and individual) would not likely be proportionate to the federal rate reductions. On the one hand, certain features of the reform proposals (e.g., repeal of various credits and other tax preferences) would not have as direct an impact on state tax bases. On the other hand, the expensing provision would have a greater proportionate effect on state taxes because of the degree to which states have already decoupled from the current bonus depreciation regime.

— With respect to individual taxes only, the ability of states to incorporate the federal reform changes of reducing rates and increasing the standard deduction likely would depend heavily on whether they also repeal the personal exemption allowances as proposed in both the President's campaign plan and the Blueprint. As noted, most states traditionally conform only to feeral AGI and determine the amount of the personal exemption allowance and the standard deduction separately from the federal determinations.

— Working in the other direction, the proposed repeal of the corporate and individual AMT and certain taxes associated with the Affordable Care Act likely would not have a significant impact at the state level.

— Recent reports indicate that a number of states are currently experiencing budget shortfalls largely because actual revenue receipts are not meeting the estimates established when the budget was adopted in the last legislative session. One research group estimates that thirty-one states will face some kind of revenue imbalance in the 2017 legislative session.[33]

— In recent years, a number of states have made tax reform proposals aimed at reducing or eliminating corporate income taxes and placing greater reliance on consumption taxes and retail sale taxes, not unlike the goals outlined in the Blueprint. Generally, these state reform proposals have been made by Republican governors. In 2017, Republicans control the governorship and hold a majority in each house of the legislature in twenty-four states.[34] Moreover, there will be a number of state reform proposals under consideration as more than fifteen states have ongoing or recently completed committees and commissions studying possibilities for tax reform independent of any response to federal reform.[35]

---

[33] Ryan Maness, *Thirty-One States Face Revenue Shortfalls for the 2017 Fiscal Year,* MultiState Insider (Jan. 3, 2017).

[34] Alabama, Arizona, Arkansas, Florida, Georgia, Idaho, Indiana, Iowa, Kansas, Kentucky, Michigan, Mississippi, Missouri, New Hampshire, North Dakota, Ohio, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, Wisconsin and Wyoming. Democrats control the governor's office and both house in six states: California, Connecticut, Delaware, Hawaii, Oregon and Rhode Island.

[35] Liz Malm, MultiState Associates Inc., *Which States Are Currently Undertaking Comprehensive Studies of their Tax Codes?* (Oct. 17, 2016), *available at* https://www.multistate.com/insider/2016/10/which-states-are-currently-undertaking-comprehensive-studies-of-their-tax-codes/.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

5. How does this square with state balanced budget requirements?

Nearly every state is required to maintain a balanced budget – either by a statutory mandate or some type of constitutional provision. The balanced budget requirement generally relates to the operating or general fund budget, which is the fund where most state tax collections are deposited and from which most state appropriations are made. Although not all states have a specific enforcement provision for failing to balance the budget, states have consistently complied with these mandates. In addition, credit markets tend to disfavor borrowing for ongoing operational needs.

The balanced budget requirements can be expected to have a bearing on whether potential federal changes would be adopted by the states. On the corporate income tax side, potential federal changes that would shrink the federal tax base or reduce a company's federal taxable income, such as a proposal for immediate expensing for certain business purchases, would likewise reduce state corporate tax revenues. Adoption of any federal changes that would appear to significantly reduce income taxes, either personal or corporate, may simply not be economically feasible for states due to balanced budget requirements. Based on information available now, it seems unlikely that states would be able to reduce their marginal income tax rates to the same relative degree that the President and the House Blueprint propose.

The balanced budget requirements may also affect the timing of when states may conform to federal changes if their propensity is to do so. That is, if the federal changes go into effect in a relatively short time frame and states feel they cannot adequately assess the impact of the revised structure on revenues, they may delay adoption of certain provisions or delay reducing rates until they have a better sense of the impact on revenues.[36]

---

[36] The National Conference of State Legislatures policy statement calls for the federal government to allow states adequate transition time to accommodate a federal reform and to make all federal changes on a prospective basis. National Conference of State Legislatures, *Letter to Reps. Charles Boustany and Richard Neal RE Hearing on Fundamental Tax Reform Proposals* (Apr. 14, 2016), available at http://www.ncsl.org/documents/statefed/Tax_Policy_Letter_041416.pdf.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

6. What would happen if states did not conform or delayed their conformity?

In short, chaos. But, until a comprehensive draft tax reform bill is released, it is hard to determine the extent of the chaos. Any new federal corporate regime that operates more akin to a cash flow tax would very likely be administratively challenging for the states. If federal taxable income is computed in a dramatically different fashion, states that wished to retain their traditional corporate income taxes would be without a unifying starting point. The possibility of two very different business tax regimes with two different bases, two different structures, and two different tax philosophies is a distinct possibility.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

Contact us

Contact a tax professional with KPMG

Harley Duncan
Managing Director
State and Local Tax, Washington National Tax
T 202-533-3254
E hduncan@kpmg.com

Ann Holley
Partner
State and Local Tax, Washington National Tax
T 202-533-3248
E aholley@kpmg.com

Sarah McGahan
Director
State and Local Tax, Washington National Tax
T 713-449-9748
E smcgahan@kpmg.com

Jeffrey Burns
Managing Director
State and Local Tax, Chicago
T 312-665-1077
E jjburns@kpmg.com

kpmg.com/socialmedia

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY KPMG TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 145,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. Printed in the U.S.A. NDPPS 645975

The KPMG name and logo are registered trademarks or trademarks of KPMG International.