Section of Taxation

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November 9, 2018

Mr. Gregory S. Matson
Executive Director
Multistate Tax Commission
444 North Capitol Street, NW
Washington, DC 20001-1538

Re: State and local taxes implications of the Federal Tax Cuts and Jobs Act of 2017

Dear Mr. Matson:

Per your request, enclosed please find a series of reports providing commentary on the implications on state and local taxes from the Federal Tax Cuts and Jobs Act of 2017, P.L. 115-97. They are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

EXECUTIVE SUMMARY

In many states, federal taxable income is the starting point for computing state taxable income. States typically conform to a taxpayer's federal taxable income in one of three ways. Rolling conformity states conform either to the Internal Revenue Code of 1986 (the "Code") as amended in effect for the tax year or conform to the taxpayer's federal taxable income (or federal taxable income before net operating loss deduction and special deductions) reported on the taxpayer's federal tax return. In contrast, a static conformity state conforms to the Code, as amended or in effect on a specific date. For example, Iowa adopts the Code as in effect on January 1, 2015.[1] Finally, hybrid states only conform to certain enumerated sections of the Code (typically as in effect on a specific date).

Rolling conformity states effectively conformed to the Act[2] without any action by the state's legislature but those states may consider decoupling from certain specific portions of the Act for various reasons. In contrast, static and hybrid conformity states are required to affirmatively amend their states' tax laws to conform to the Act. If a state static or hybrid conformity state fails to conform to a portion of the Act, the taxpayer must compute taxable income with respect to that item in accordance with the state's existing law as if the Act had not taken effect.

Any time a rolling conformity state decouples from federal tax law, or a static or hybrid state fails to conform to federal tax law, a taxpayer required to file a return in the state incurs an additional administrative burden because the taxpayer is required to compute state taxable income separate from federal taxable income. For example, in a static conformity state that conforms to the Code in effect on January 1, 2015, the taxpayer must compute state taxable income under the federal tax rules in effect on January 1, 2015. In addition, the state assumes an additional administrative burden because its department of revenue must incur additional costs to audit the taxpayer's return (*i.e.*, the state cannot piggy-back off the work performed by federal auditors).

The decision to conform or not will be influenced by policy and revenue considerations. The Section generally supports conformity to the federal system for reasons of administrative convenience for both taxpayers and tax administrators, but we recognize that there can be circumstances in which these benefits can be outweighed by other considerations.

This report highlights considerations for states and localities in the various substantive tax areas affected by the Act.

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[1] Iowa Code § 422.32(1)(h).

2 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (sometimes referred to as the "Tax Cuts and Jobs Act" or "TCJA").

SECTION 1: Accelerated Depreciation and Business Interest Deduction Limits

Accelerated Depreciation and Business Interest Deduction Limits

I. Accelerated Depreciation – Section 168(k)[1]

A. Federal Overview

Under section 168(k), a taxpayer may deduct the cost of certain capital expenditures in the year in which the property is placed in service. This full expensing regime applies to property placed in service after September 27, 2017, and before January 1, 2023.[2] There is a 20% annual phase-down for property placed in service after December 31, 2022, to zero in 2027 and thereafter.[3] Qualified property generally includes computer software and tangible property with a recovery period of 20 years or less.[4] The rules apply to property newly placed in service and to used property acquired from an unrelated taxpayer if certain conditions are met, but not to property currently used by the taxpayer. For property placed into service in the first taxable year after September 27, 2017, taxpayers may elect to use a 50%-expensing rate in lieu of full expensing.[5] A transition rule generally maintains the current bonus depreciation rates for qualified property acquired before September 28, 2017, and placed in service after September 27, 2017.[6]

B. State Considerations

The federal change was intended to encourage businesses to invest in and expand their operations. The ultimate objective is to create jobs. States and localities should consider whether they should conform to the federal change as part of their economic development policies.

Many states already decouple from bonus depreciation under prior section 168(k). Absent legislative changes (beyond a change in a conformity date to the Code), the decoupling from Section 168(k) will likely carry over to the expensing rules in amended section 168(k). These states would have to amend their statutes to adopt an expensing regime. States should also consider the complexity for taxpayers and revenue departments of a failure to conform to the federal rules.

States that have decoupled from bonus depreciation under section 168(k) generally either provide another depreciation schedule or disallow the depreciation deduction in its entirety. For example, Florida, in legislation enacted in response to the Act, amended its law to require the

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[1] References to "section" are to a section of the Internal Revenue Code of 1986 as amended (the "Code"), unless otherwise indicated. References to "prior section" are references to sections prior to their amendment by the Act.

[2] I.R.C. § 168(k)(1), (6).

[3] I.R.C. § 168(k)(8).

[4] I.R.C. § 168(k)(2).

[5] I.R.C. § 168(k)(10).

[6] I.R.C. § 168(k)(8).

add-back to income of the full amount deducted under amended section 168(k).[7] Taxpayers are then permitted to use a straight-line seven-year depreciation schedule.[8] The provision of an alternative depreciation schedule (after the add-back of the federal deduction under section 168(k)) merely operates as a timing difference for taxpayers. This timing difference is more taxpayer friendly-than wholly denying any form of depreciation, although it does result in additional compliance costs.

II. Business Interest – Section 163(j)

A. Federal Overview

Generally, section 163(j), as amended by the Act, limits a taxpayer's[9] (not just a corporation's)[10] net business interest expense deduction to 30% of the taxpayer's adjusted taxable income ("ATI") plus business interest income and floor plan financing income.[11] Business interest means any interest properly allocable to a trade or business.[12] A taxpayer's ATI is its taxable income computed without regard to: (1) income, deduction, gain, or loss not properly allocable to a trade or business; (2) business interest income and expense; (3) any net operating loss deduction; (4) any qualified business income deduction;[13] and (5) for tax years beginning before 2022, any deduction allowable for depreciation, amortization, or depletion.[14] Depreciation is excluded from the calculation for tax years beginning before 2022, which is the applicable period for the full expensing provisions under section 168(k).

The amount of a taxpayer's net business interest expense that exceeds 30% of its ATI is disallowed as a deduction ("disallowed business interest").[15] The disallowed business interest is

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[7] Fla. Stat. § 220.13(e).

[8] *Id*.

[9] *See* Notice 2018-28, Section 2, 2018-16 I.R.B. 492 (noting that the amended section 163(j) limitation applies to all taxpayers, except for certain taxpayers that meet the gross receipts test in Section 448(c), and to all trades or businesses, except for those listed in section 163(j)(7)).

[10] *See* Committee Report at 228 fn 688 (in discussing the House Bill, which is consistent with the relevant provisions as enacted, the report indicates that in the case of corporate taxpayer, all interest paid or accrued in the taxable year is treated as "business interest" unless specifically excluded). Partnerships and S corporations are also subject to the business interest limitation rules (with some modifications).

[11] I.R.C. § 163(j)(1). In this regard, the amended section 163(j) is more encompassing than the prior section 163(j), which disallowed interest deductions on certain interest payments to related parties not subject to federal income tax on their interest income and on interest payments to unrelated parties in instances where a related party guaranteed the debt.

[12] I.R.C. § 163(j)(5).

[13] That is, the 20% deduction for certain pass-through income under new section 199A.

[14] I.R.C. § 163(j)(8). The Act authorizes the Department of the Treasury and the Internal Revenue Service ("Service") to provide adjustments to the ATI computation. ATI will not be less than zero.

[15] I.R.C. § 163(j)(2).

treated as business interest paid or accrued in the next succeeding year and is deductible to the extent that the taxpayer's net business interest expense is less than 30% of its ATI plus floor plan financing income. Any business interest that is disallowed is carried forward indefinitely until used.

The Service issued Notice 2018-28 to clarify certain aspects of section 163(j): (i) a group filing a consolidated return is treated as a single taxpayer;[16] (ii) when calculating the limitation of section 163(j), the consolidated group's ATI will be its consolidated taxable income, disregarding any intercompany obligations;[17] (iii) any interest disallowed under the former section 163(j) may be carried forward as business interest in the taxpayer's first taxable year beginning after January 1, 2018, which will then be treated as business interest subject to the limitations of amended section 163(j);[18] and (iv) for subchapter C corporations, all interest is treated as business interest for purposes of section 163(j), and all interest included in the gross income of a C corporation is business interest income for purposes of section 163(j).[19]

B. State Considerations

In deciding whether to adopt the interest deduction limitations, states and localities should consider their linkage to the expensing provisions of section 168(k). The reason Congress adopted the interest deduction limitations was to backstop the expensing provisions. Congress was concerned that if interest deductions were not limited taxpayers could obtain a double tax benefit by borrowing to buy business assets, deducting the cost of the assets immediately in the year in which they were placed in service, and then deducting the interest on the loan. The linkage is shown by the provisions in the Act that allow certain real property and farming businesses to elect not to be subject to the interest deduction limitations but only if they forgo the right to adopt full expensing.[20] States that have not adopted the new federal expensing regime under section 168(k) should seriously consider not adopting the limits on deducting business interest under section 163(j).

States that do decide to conform to the business expense deduction limits will have to address a number of issues. First, a state will need to determine how the section 163(j) limitation will operate with its statutory filing methodologies. Although the Service has issued guidance that a group filing a consolidated return is treated as a single taxpayer for section 163(j) purposes,[21] states may require some taxpayers to file separately or as part of a state consolidated or state combined group that differs from the federal consolidated group. While intercompany transactions, including intercompany interest expense/income, are typically eliminated in state

[16] Notice 2018-28, Section 5.

[17] *Id.*

[18] Notice 2018-28, Section 3. Such amounts of carried forward disallowed interest limited by former section 163(j) will only be limited in their use to the extent of amended section 163(j).

[19] Notice 2018-28, Section 4.

[20] *See* I.R.C. §§ 163(j)(7)(A) and 168(k)(9).

[21] Notice 2018-28, Section 5.

consolidation and combination, third-party interest expense/income is not. When there is a disconnect between the make-up of the federal reporting group and the state reporting group, the eliminations of intercompany transactions at the state level may not mirror those eliminations of the federal consolidated group. This disconnect from the make-up of the federal reporting group is even more evident in separate filing states. As a result, corporate taxpayers that have interest expenses are likely to experience some disconformity regardless of filing methodology.

Second, to determine how conformity to section 163(j) will operate for corporate taxpayers, conforming states should be prepared to answer the basic question of how the section 163(j) limitation is to be allocated among the federal consolidated group members individually. In a consolidated or combined group state that differs from the federal group, how will the limitation be recalculated for, or the deduction allowance be spread among the members of, the federal group so they can be reflected in the income amounts of the relevant state taxpayer or state filing group? In separate reporting states, the question becomes whether the limitation calculation will be applied "as though filing separate" or using some other method for determining what, if any, portion of the federal deduction allowance is attributed to the individual entity.

Third, regardless of filing method, states will also need to be cognizant of how, if at all, they will conform to the federal carryforward treatment of the previously disallowed business interest expense and how those amounts will then allocated among the relevant state filers and filing groups. If the state conforms, will this carryforward be on a pre- or post- apportionment basis?

Fourth, states will need to provide guidance regarding the interplay between section 163(j) and existing intercompany interest expense add-back requirements. Many states limit the extent to which interest paid to related taxpayers can be deducted. A state that conforms to section 163(j) and has an intercompany interest expense add-back will have two limitations: (i) a 100% disallowance for intercompany interest expense subject to add-back; and (ii) a 70% (of ATI plus business interest income and floor plan financing income) disallowance for all business interest expense. The interplay of these limitations is complicated by the fungibility of cash – in this case, borrowed cash. Taxpayers will need to determine whether interest deductions disallowed under the state intercompany interest expense add-back was a component of the amount allowed or of the amount disallowed under the federal limitation. This becomes further complicated if the assumption is that the intercompany interest expense to be disallowed at the state level was part of the business interest expense disallowed at the federal level because the federally disallowed interest can carry forward indefinitely and can eventually be used. Should, for example, the state intercompany add-back apply at that time of future federal use?

Last, states may need to consider what impact any disallowed business interest under section 163(j) may have on the existing exceptions to the add-back statute, particularly any exceptions based on amounts ultimately paid by the affiliated group to third parties (so-called "conduit" exceptions). The fact that section 163(j) deems disallowed interest expense to be "paid" in the succeeding tax year could adversely impact the ability of a taxpayer to satisfy the conduit exception by the deemed reduction to the amount of interest it paid or its affiliate paid to a third party in the current tax year.

SECTION 2: Capital Contributions by Governments

Capital Contributions by Governments

I. Federal Overview of Capital Contributions by Governments

The Act contains a significant change to the treatment of certain state and local tax incentives for federal income tax purposes. Under prior law, section 118 excluded capital contributions by a governmental entity to a corporate taxpayer from the definition of gross income and, hence, from taxable income. Under the Act, section 118 was amended to provide that contributions made by a governmental entity or civic group cannot be excluded as "contributions to capital."

While the changes are generally effective for contributions made after the effective date of the Act (*i.e.*, December 22, 2017), an exception applies to contributions made after the effective date but pursuant to a master development plan approved by the governmental entity prior to December 22, 2017.

According to a summary of the House version of the proposal, the provision is intended to "remove a Federal tax subsidy for State and local governments to offer incentives and concessions to businesses that locate operations within their jurisdiction (usually in lieu of locating operations in a different State or locality)."[1] By reversing the treatment of these contributions under section 118, money or property provided to a company by the federal, state, or local government will likely be included in taxable income at the federal (and possibly state and local) level, unless another exception applies. For example, this change affects cash grants, public infrastructure and improvement grants, no-cost land, and reimbursements by government entities.

Other state and local incentives, such as nonrefundable tax credits, deductions, abatements, and exemptions should not constitute taxable income at the federal level and are instead considered to be a reduction of the taxpayer's state or local tax liability that would otherwise be eligible for a federal deduction. While the change to section 118 is estimated to raise revenues during the ten-year budget window, companies that are required to include these incentives in taxable income should receive basis in such property equal to the amount of income recognized (under prior law, the recipient's basis in the property was zero due to the section 118 exclusion).[2]

II. State and Local Issues to Consider

Jurisdictions that automatically conform to the federal definition of taxable income will have to decide whether to decouple from the section 118 amendments. Accepting the federal changes could undermine states' economic development efforts and policies by creating an additional tax burden on affected capital contributions, thus reducing the benefit of such state incentives. Although conformity is generally desirable for reasons

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[1] Report of the Committee on Ways and Means, House of Representatives, on H.R. 1, Tax Cuts and Jobs Act, p. 256, Nov. 13, 2017, available at https://www.congress.gov/115/crpt/hrpt409/CRPT-115hrpt409.pdf.

[2] *See* I.R.C. § 362.

of administrative convenience, states and affected taxpayers should be amenable to decoupling from this provision to at least reduce the state income tax burden from contributions to capital. However, decoupling could eliminate a new source of tax revenue.

Other jurisdictions that conform to the Code as of a date preceding the effective date of this change or that do not conform to section 118 will have to decide whether to adopt the section 118 amendments. Adopting the federal change would reduce benefits that the state or local governments anticipated providing to taxpayers. Nonetheless, not adopting the Act change could eliminate a new source of tax revenue.

Jurisdictions should also consider issuing guidance on the transition rule and definition of "master development plan." Florida and the District of Columbia both passed legislation clarifying the phrase "master development plan" for purposes of the December 22, 2017 transition rule.[3]

Jurisdictions should evaluate existing state and local incentive programs and agreements based on the potential additional income tax (federal and possibly state) cost and determine whether to restructure such programs. For example, jurisdictions could replace capital contributions with nonrefundable tax credits from the state income tax or provide deductions, abatements, or other exemptions from income, sales/use, or property taxes to avoid the additional federal income tax cost that would have likely resulted from the capital contribution. Coordination between state and local governments will be critical to ensure that the capital contributions being offered by state and local governments are adequately being offset by the nonrefundable income tax credits or other measures used to offset or mitigate the additional federal income tax cost.

[3] D.C. Act 22-636 (passed Dec. 29, 2017), available at https://legiscan.com/DC/text/B22-0636/id/1664215; and FL House Bill 1115 (enacted Apr. 6, 2018) available at https://www.flsenate.gov/Session/Bill/2018/1151/BillText/er/PDF

SECTION 3: Accounting Method Changes

Accounting Method Changes

The Act contains several changes to federal accounting methods (*e.g.*, expansion of the cash basis method of accounting and inventory accounting changes) that a state should consider when determining whether to conform to the Act, because these changes may impact a state's income tax base and ultimately increase or decrease the revenue generated by that state's income tax. When determining whether to conform to the Act's accounting method changes, a state should also consider the potential increased administrative burden on taxpayers and the state's department of revenue that may result from decoupling from the federal changes. Causes of an additional increased administrative burden associated with non-conformity to the Act's accounting method provisions include increased recordkeeping complexity, the performance and auditing of multiple tax calculations related to the same item, and costs associated with seeking permission from a state to adopt a non-conforming accounting method used for federal income tax purposes.

I. Federal Overview of Accounting Methods

An accounting method includes both the method of accounting on the basis of which a taxpayer regularly computes income in keeping books and the specific accounting treatment of particular items.[1] Electing or changing an accounting method does not change whether an item will be included or deducted from the taxpayer's income, but it may change the tax period in which the item is included in or deducted from the taxpayer's income.[2] For federal income tax purposes, generally, once a taxpayer has adopted a method of accounting, the taxpayer must file Form 3115 with the Internal Revenue Service (the "Service") and obtain the Service's consent to change its accounting method. But the Service also permits a taxpayer to make certain accounting method changes without the Service's consent, which are referred to as automatic method changes.

The Act amended several federal tax laws that relate to accounting methods, which are summarized in Appendix 1. These changes may result in certain taxpayers changing certain methods of accounting used on their federal income tax returns. Those changes include expanding the ability of a taxpayer to use the cash method of accounting, changes to inventory accounting, and changes to long-term contract accounting.

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[1] Reg. § 1.446-1(a)(1).

[2] Reg. § 1.446-1(e)(2)(ii)(b) (An accounting method change is a change that only involves the proper time for the inclusion of an item of income or the taking of a deduction. It does not include correction of an error or the reclassification of an item of income or deduction.).

Section 481 and associated administrative guidance require a taxpayer to make certain adjustments in connection with an accounting method change to avoid duplication or omission of income in the year of change and, in certain instances, provide relief provisions in connection with these adjustments.[3] Section 481 and the related guidance also permit a taxpayer to allocate the additional tax due caused by certain accounting method changes that result in the recognition of a substantial additional tax liability in the year of the method change over multiple tax periods. The Act amended section 481 to permit the allocation of additional tax due over a six-year period if the additional tax was caused by the conversion of certain subchapter S corporations to subchapter C corporations.[4]

II. State Conformity Issues Related to Accounting Method Changes

With respect to reporting accounting method changes, when a state decouples from a federal accounting method or section 481, a taxpayer must report an item in different tax periods for federal and state tax purposes and incurs an additional administrative burden of tracking those federal/state differences. Similarly, a state's department of revenue incurs increased costs to audit that particular item to ensure it is properly reported for state tax purposes.

A. Record Keeping Complexity

If a state chooses to decouple from the federal accounting method rules, taxpayers could be required to use different accounting methods for state and federal tax record keeping and reporting purposes. For example, an affected taxpayer might elect the cash-basis method of accounting for federal income tax purposes but be required to keep a separate set of records using the accrual-method for state income tax purposes and report state income taxes on the basis of the separate set of books. With respect to accounting method changes in situations in which state and federal rules are inconsistent, recordkeeping requirements and expense will increase significantly as, in many instances, two sets of records must be kept to support federal and state tax filings. Similarly, decoupling from federal accounting methods could create an increased administrative burden on an already resource constrained state department of revenue because in an audit, the department of revenue could no longer rely on the taxpayer's federal taxable income as a starting point.

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[3] Under section 481(a), in computing taxable income for the year the accounting method is changed, only those adjustments necessary because of the change in order to prevent duplication or omission must be taken into account. Section 481(b) and (c) permit a taxpayer to allocate the additional tax caused by certain method changes over multiple tax years.

[4] I.R.C. § 481(d).

It should be noted that many of the accounting methods now permitted by the Act were created to minimize the administrative burden on small business. A state considering decoupling from these provisions of the Act should consider whether the additional administrative burden resulting from the lack of conformity will undermine the purposes of those sections of the Act and create significant burdens on its in-state small business taxpayers.

B. Permission to Change Accounting Method and Related Adjustments

Most states provide for automatic state level accounting method changes when a federal accounting method change is permitted.[5] Other states may require independent state approval of an accounting method change.[6] When reviewing a state's conformity to the Act, a state legislature should consider how the state conforms to federal accounting method changes and determine whether additional state law amendments are allowed to mitigate the administrative burden associated with a taxpayer's request to change its accounting method in a manner that conforms to the Act.

Many, but not all, states conform to section 481 or have enacted state law provisions equivalent to section 481.[7] Static conformity states may conform to a version of section 481 enacted before the Act and, hence, do not conform to section 481 as amended by the Act.[8] Similarly, hybrid conformity states with their own version of section 481 would also need to amend their law to conform to section 481 as amended by the Act.[9] Static or hybrid conformity states and other states that have enacted their own version of section 481 should consider whether it is appropriate to amend their state's tax law to include the new provisions added to section 481 by the Act. In addition, a state that intends to conform to the Act but that does not have a state law equivalent of section 481 should consider the potential revenue impacts and burdens on taxpayers associated with a taxpayer making an accounting method change now permitted or required by section 481. Decoupling from the allocation provisions in section 481 could cause a taxpayer to report income and loss inconsistently for state and federal income tax

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[5] *See e.g.*, Ala. Admin. Code Sec. 810-3-13-.04(2); Cal. Franchise Tax Board Notice 2000-8; Fla. Stat. Sec. 220.42; La. R.S. Sec. 47:287.441; Ga. Comp. R. & Regs. Sec. 560-7-5-.02(5); 20 NYCRR Sec. 2-2.2(a); Utah Code Ann. Sec. 59-7-501(3); and Va. Code Ann. Sec. 58.1-440.

[6] *See, e.g.*, Cal. Rev. & Tax. Cd. Sec. 24651(e) (Note there is a safe harbor in Cal. Franchise Tax Board Notice 2000-8 for certain federal method changes).

[7] *See e.g.*, S.C. Code Ann. §12-6-4420(B)(2); W. Va. Code §11-24-8(f); Wis. Stat. §71.30(1)(b).

[8] For example, California conforms to section 481 as amended through January 1, 2015, regarding adjustments to be made in connection with a change in accounting method. Cal. Rev. & Tax. Cd. Sec. 24721 and 17024.5.

[9] For example, Kansas provides for its own section 481-style adjustment to compute changes over multiple tax years. Kan. Stat. Ann. Sec. 79-32,114(d)(ii).

purposes, which may put an increased burden on both a taxpayer and a state's department of revenue.

The summary in Appendix 1 addresses the most significant accounting method changes permitted by the Act and certain other provisions that may cause a taxpayer to change its method of accounting. It should also be noted that the Service has indicated that it will continue to grant accounting method changes for the 2017 tax year that are designed to accelerate deductions or defer income in order to reduce a taxpayer's 2018 income tax, including method changes related to calculating depreciation and capitalization. But the Service has also issued guidance indicating that it will disregard an accounting method change made by a specified foreign corporation for a tax year that ends in 2017 or 2018 if that change in method of accounting would reduce the one-time transition tax on untaxed accumulated earnings and profits in section 965.[10]

[10] Notice 2018–26, 2018-10 I.R.B. 390.

SIGNIFICANT FEDERAL ACCOUNTING METHOD CHANGES RELATED TO THE ACT	
Tax Law Change	**Accounting Method Changes**
Cash Method of Accounting – Expansion to Small Businesses	The Act amended section 448 to expand the types of taxpayers eligible to use the cash method of accounting.[11] Pre-Act tax law restricted the use of the cash method of accounting for subchapter C corporations, partnerships with a C corporation partner, certain farming business, and, indirectly, for a taxpayer that used an inventory method to account for purchases and sales (discussed below). Specifically, section 448(a) provided that a C corporation, a partnership with a C corporation partner, or a tax shelter could not use the cash method of accounting unless an exception applied. Exceptions included a farming business, a qualified personal service corporation, and an entity that satisfied the gross receipts test. The gross receipts test, defined in section 448(c), created an exception for a C corporation or partnership if, for all prior tax years beginning after December 31, 1985, the average annual gross receipts of the entity for the three-tax-year period ending with the earlier tax year did not exceed $5,000,000 (unadjusted for inflation). In applying the test, the gross receipts of certain related taxpayers were aggregated. The Act amended the gross receipts test in section 448(c) to increase the average annual gross receipts limitation from $5,000,000 to $25,000,000 (indexed for inflation) and amended the testing period to include only the three-year period that precedes the tax year for which the taxpayer is being tested. The Act also amended section 448(d)(7) to apply the general rules for section 481 to any method change made under section 448. These changes are effective for tax years beginning after December 31, 2017.

[11] The Act also amended section 447 to expand the universe of taxpayers engaged in farming that are eligible to use cash method of accounting by referencing the gross receipts test in section 447(c) to section 448(c) and applying the general rules for section 481 to any method change made under section 447.

Alternatives to Inventory Accounting and Additional Expansion of Cash Method of Accounting	The Act amended section 471 to allow alternatives to inventory accounting and to indirectly expand the types of taxpayers eligible to use the cash method of accounting. Pre-Act, section 471 provided that, unless an exception applied, if the Service determined that the use of inventories was necessary to clearly determine a taxpayer's income, the taxpayer was required to use an inventory method. The regulations under section 466 require a taxpayer that uses inventory accounting to use the accrual method of accounting. The Act amends section 471 to say that any taxpayer that satisfies the gross receipts test in section 448(c), discussed above, is not required to use inventory accounting. In the case of any taxpayer that is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership. Under the new rules, the taxpayer's method of accounting for inventory for the taxable year shall not be treated as failing to clearly reflect income if its method either: (1) treats inventory as non-incidental materials and supplies; or (2) conforms to such taxpayer's method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year or, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures. Any taxpayer not required to use an inventory method of accounting under amended section 471 is not required to use the accrual method of accounting. This change is effective for tax years beginning after December 31, 2017.

Expansion of Small Business Exception to UNICAP Rules	The Act amended section 263A to expand the small business exception to the Uniform Capitalization ("UNICAP") rules. Unless an exception applies, the UNICAP rules, section 263A, require a taxpayer to capitalize the direct costs and certain indirect costs allocable to real tangible personal property that the taxpayer produces into the property's basis. In addition, a taxpayer must include the cost of real or personal property purchased for resale in inventory. Before the Act, small business exception in section 263A did not apply to **personal property** acquired **for resale** during a tax year if the taxpayer's average annual gross receipts for the immediately preceding three years did not exceed $10,000,000. The Act expanded the UNICAP exception for small business under section 263A(i) to any taxpayer that satisfies the gross receipts test in section 448(c). As a result, the UNICAP small business exception now applies to any producer or reseller of either real or personal property that satisfies the $25,000,000 gross receipts test. A taxpayer that qualifies for the exception may now deduct these costs in the year incurred. In the case of any taxpayer that is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership. This change is effective for tax years beginning after December 31, 2017.

Expansion of Small Construction Contract Exception to Percentage of Completion Method	The Act amended section 460 to expand the small business exception to the long-term contract rules. Unless an exception applies, section 460 requires that a taxpayer must determine the amount included in income from a long-term contract using the percentage-of-completion method. Before the Act, section 460(e) created an exception to the required use of the percentage-of-completion method for certain small construction contracts. The contract exception applied a contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property entered into by a taxpayer: (1) who estimated that the contract would be completed within two years of the commencement of the contract; and (2) whose average annual gross receipts for the prior three tax years did not exceed $10,000,000. Income from these contracts was reported using the method the taxpayer used to account for its long-term contracts that were exempt from the percentage-of-completion method, e.g., the completed contract method, the exempt-contract percentage-of-completion method, the percentage-of-completion method, or any other applicable method. The Act expanded the scope of the small construction contract exception by amending the gross receipts test to incorporate the $25,000,000 gross receipts test in section 448(c), discussed above. In the case of any taxpayer that is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership. A method change under section 460(e) change shall be effected on a cut-off basis for all similarly classified contracts entered into on or after the year of change. This change is effective for tax years beginning after December 31, 2017.

Revision to the "All Events" Test for Certain Advance Payments	The Act modifies the "all events" test used by accrual method taxpayers to determine when an amount is included in income. Before the Act, the regulations under section 451 provided that an accrual method taxpayer included an amount in income when all the events had occurred which fix the right to receive such income and the amount of such income could be determined with reasonable accuracy. The Act added new section 451(b) to the Code. Section 451(b)(1)(A) modifies the all events test by providing that the all events test with respect to any item of **gross income** shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in either: (1) an applicable financial statement of the taxpayer, or (2) such other financial statement as the Secretary may specify. New section 451(b)(3) provides a list of applicable financial statements. New section 451(b)(1)(B) states that the limitation on the all events test does not apply to a taxpayer that does not have a financial statement for a taxpayer year or any item of gross income in connection with a mortgage servicing contract. In addition, the limitation to the all events test also does not apply to any item of gross income for which the taxpayer uses a special method of accounting. New section 451(b) only applies to gross income inclusion and not loss inclusion. Because the provision in new section 451(b) only applies to items of gross income, it does not appear to apply to certain items, including the net gain on the sale of assets of items related to non-recognition provisions. It is not clear whether new section 451(b) applies to income from a debt instrument that is subject to the original issue discount rules. The term "special method of accounting" is not defined but it appears that term may include items accounted for under the mark-to-market rules, the rules related to hedging transactions, or other methods of accounting provided in certain Code sections. This change is generally effective for tax years beginning after December 31, 2017. The section 481 rules apply to a change in method of accounting made under these rules for the taxpayer's first taxable year beginning after December 31, 2017. But in the case of income from a debt instrument having original issue discount the period the amendments made by this section of the Act are effective for tax years beginning after December 21, 2018 and the period for taking into account any adjustments under section 481 shall be 6 years.

Exception to the "All Events" Test for Certain Advance Payments	The Act modifies when accrual method taxpayers should include an advance payment in income. As noted above, before the Act, an accrual method taxpayer was required to include an advance payment in income in the year of receipt unless an exception applied.[12] Under new section 451(c), which codifies the deferral method of accounting under Rev. Proc. 2004-34, an accrual-basis taxpayer must include an advance payment in income when the taxpayer actually or constructively receives the payment. But several exceptions apply to the general rule in new section 451(c). Most importantly, a taxpayer may elect, with respect to the category of advance payments to which such advance payment belongs, to include only the portion of the payment required by new section 451(b), above, to be included in income in the year received and include the remaining portion of the advance payment in gross income in the taxable year following the taxable year in which the payment is received. Thus, under the Act, if the election is made, income from an advance payment may only be deferred if it is deferred for up to one year, assuming it is also deferred for financial statement purposes. An "advance payment" is any payment: (1) the full inclusion of which in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting under section 451 (without regard to new section 451(c); (2) any portion of which is included in revenue by the taxpayer in a financial statement for a subsequent taxable year; and (3) which is for goods, services, or such other items as may be identified by the Secretary. Rent, insurance premiums, payments with respect to financial instruments, and certain other payments are not advance payments. This change is effective for tax years beginning after December 31, 2017. The section 481 rules apply to a change in method of accounting made under these rules for the taxpayer's first taxable year beginning after December 31, 2017.

[12] Rev. Proc. 2004-34

Amortization of Section 174 Research and Experimental Expenditures	The Act requires the amortization of certain section 174 research and experimental ("R&E") expenditures incurred in tax years beginning after December 31, 2021. Under the pre-Act rules, a taxpayer could elect to either deduct R&E expenditures in the year incurred or amortize the expense ratably over the useful life of the research, but a period of not less than 60 months. In the alternative, a taxpayer could elect to amortize its R&E expenditures over 10 years to avoid an alternative minimum tax preference and adjustment. Unless an exception applies, no current deduction was available under section 174 for expenditures related to the acquisition or improvement of land or of depreciable or depletable property used in connection with research or experimentation. Under the Act, for tax years beginning after December 31, 2021 a taxpayer must charge R&E expenditures to a capital account and amortize them ratably over a five-year period beginning with the mid-point of the tax year in which the taxpayer incurred the expenditure. No other deduction for R&E expenditures is allowed. R&E expenditures attributable to foreign research must be amortized over a 15-year period. Amortizable R&E expenditures do not include the cost of land or depreciable or depletable property used in connection with research and experimentation but do include the related depreciation and deletion allowances. Any amount paid or incurred in connection with the development of any software shall also be treated as a research or experimental expenditure. If property with respect to which research or experimental expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction, no deduction shall be allowed with respect to such expenditures on account of such disposition, retirement, or abandonment and such amortization deduction shall continue with respect to such expenditures. Any change in method of accounting related to the amendments to section 174 shall be applied on a cut-off basis for any research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021, and no adjustments under section 481(a) shall be made. The amendments to section 174 apply to amounts paid or incurred in taxable years beginning after December 31, 2021.

SECTION 4: Tax-Exempt Organizations

Tax-Exempt Organizations

I. Changes to Use of Losses in Computing Unrelated Business Taxable Income

A. Federal Overview

For taxable years beginning before 2018, a tax-exempt organization that was engaged in conducting more than one unrelated trade or business generating unrelated business taxable income ("UBTI") could aggregate the income, gain, deductions, and expenses generated by all of its unrelated trades or businesses to determine whether it had net UBTI resulting in an unrelated business income tax ("UBIT") liability or in a net operating loss. For example, a tax-exempt organization that was engaged in one unrelated trade or business generating net UBTI of $1000 and another unrelated trade or business generating a net operating loss of $1000 could offset its $1000 of net UBTI from the profitable trade or business by its $1000 net operating loss from the other unrelated trade or business, resulting in no net UBTI and no UBIT liability.

The Act included a new provision requiring "basketing" with respect to tax-exempt organizations engaged in more than one unrelated trade or business.[1] In the post-Act environment, a tax-exempt organization that is engaged in more than one trade or business cannot apply the loss of one business against the profits of another. For example, under the new law, a tax-exempt organization engaged in an unrelated trade or business generating net UBTI of $1000 and another unrelated trade or business generating a net operating loss of $1000 cannot offset its $1000 net operating loss against its $1000 of UBTI. Its $1000 of UBTI from the profitable business will be subject to the highest federal corporate income tax rate of 21%, resulting in $210 of UBIT and it will have a $1000 net operating loss carryforward with respect to its other unrelated trade or business.

B. Impact of New Law on Tax-Exempt Organizations and State and Local Taxes

The Act's change to the manner in which a tax-exempt organization determines its net UBTI or net operating loss from the conduct of more than one unrelated trade or business by requiring "basketing" with respect to such activities will increase the federal income tax liability of many tax-exempt organizations that are engaged in multiple unrelated trades or businesses. The Act will have a similar effect in states that tax unrelated business income and conform to the federal law. State policy makers will have to decide whether the increase in state revenue will be justified by the added burden on non-profit organizations, many of which receive state financial support. Another consideration will be the complexity resulting from non-conformity with federal law.

[1] I.R.C. § 512(a)(6).

II. Increased Amount of UBTI for Certain Fringe Benefits

A. Federal Overview

The Act added a provision that requires a tax-exempt organization's UBTI to be increased by any amount for which a deduction is no longer allowable under other applicable sections of the Code, and which is paid or incurred by such organization for (i) any qualified transportation fringe benefit (as defined in section 132(f)); (ii) any parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in section 132(j)(4)(B)).[2] This new provision does not apply to the extent that the amount so paid or incurred is directly connected to an unrelated trade or business.

B. Impact of New Law on Tax-Exempt Organizations and State and Local Taxes

This modification requiring UBTI to be increased by the provision of certain fringe benefits will increase the federal income tax liability of many tax-exempt organizations. Since a vast majority of states and localities subject a tax-exempt organization's net UBTI to state and local taxation and use an organization's federal net UBTI as the basis (albeit often with adjustments) for doing so, states and localities should expect that this modification also will generate additional tax revenue. State policy makers will have to decide whether the increase in state revenue will be justified by the added burden on non-profit organizations, many of which receive state financial support. Another consideration will be the complexity resulting from non-compliance with federal law.

III. Tax on Excess Tax-Exempt Organization Executive Compensation

A. Federal Overview

Under prior law, if the Service determined that an executive's compensation was unreasonable, the excise tax on excess benefit transactions contained in section 4958 would be imposed on the executive and the tax-exempt organization's management involved in setting the amount of the executive's compensation.

The Act retains the intermediate sanctions for excess benefit transactions involving the payment of unreasonable compensation and imposes a new 21% tax (i) on any remuneration paid by a tax-exempt organization to a "covered employee" in excess of $1,000,000; and (ii) on any "excess parachute payment" paid by a tax-exempt organization to a "covered employee."[3] The tax applies not only to organizations exempt from federal income taxation under section 501(a) but also to farmers' cooperative organizations, organizations whose income is excluded from

[2] I.R.C. § 512(a)(7).[3] I.R.C. § 4960. The tax is imposed at the rate under section 11.
[3] I.R.C. § 4960. The tax is imposed at the rate under section 11.

taxation under section 115(1), and political organizations under section 527. A "covered employee" is any employee who (i) is one of the five highest-compensated employees of the organization for the taxable year or (ii) was a covered employee of the organization for any preceding taxable year beginning after 2016. The amount of remuneration paid to an executive includes cash and the cash value of all remuneration so paid, including benefits (other than payments to a tax-qualified retirement plan and employer-provided benefits otherwise excludable from income). It also includes remuneration paid by a related person or government entity. An "excess parachute payment" is a payment that is contingent upon an employee's separation from employment and the aggregate present value of which is at least three times the employee's base compensation. Amounts paid to a licensed medical professional for the performance of medical or veterinary services are not subject to the new tax.

B. Impact of New Law on Tax-Exempt Organizations and State and Local Taxes

The enactment of the new tax imposed on excess compensation of tax-exempt organization's executives will increase the federal income tax liability of some tax-exempt organizations. Unless states or localities enact a similar new tax, this new provision will not have any impact on state and local taxation or on states' and localities' coffers because it is a separate tax and does not increase taxable income. State policy makers will have to decide whether to impose a similar tax. No complexity would result from a failure to conform to the federal changes.

IV. Increased Deduction Limitation for Certain Cash Contributions by Individuals

A. Federal Overview

Before the enactment of the Act, the amount of an individual's charitable contribution deduction under section 170 was generally limited to 50% of his or her modified adjusted gross income for gifts made to certain qualified charitable recipients (mostly, organizations described in section 501(c)(3) and not classified as a private foundation within the meaning of section 509(a)).[4]

The Act increased the amount of an individual's charitable contribution deduction limitation under section 170 to 60% of his or her modified adjusted gross income for gifts of cash made to qualified charitable recipients.[5] As currently enacted, this increase is temporary, applying to charitable contributions made for any taxable year beginning after 2017 and before 2026.

[4] *See* Prior I.R.C. § 170(b)(1)(A).
[5] I.R.C. § 170(b)(1)(G).

B. Impact of New Law on Tax-Exempt Organizations and State and Local Taxes

The impact of the temporary increase to an individual's charitable contribution deduction limitation under section 170, as amended by the Act, is unknown with respect to tax-exempt organizations. For states' and localities' laws that track federal income tax law in determining the amount of an individual's charitable contribution deduction, the temporary charitable contribution deduction limitation increase may reduce tax revenues; however, the actual impact, if any, is difficult to estimate. State policy makers may conclude that it would be desirable to encourage charitable giving by conforming to the federal change.

V. Repeal of Deduction for Contributions in Exchange for College Athletic Event Seating Rights

A. Federal Overview

For taxable years beginning before 2018, 80% of an amount contributed to a college or university that entitled the contributor to a preferential right to purchase tickets or seating to an athletic event was eligible for a charitable contribution deduction under section 170.

The Act repealed the partial charitable contribution deduction for any portion of an amount contributed to a college or university that entitled the contributor to preferential rights to purchase tickets or seating to an athletic event.[6] The repeal is effective with respect to contributions made in taxable years beginning after 2017.

B. Impact of New Law on Tax-Exempt Organizations and State and Local Taxes

The impact of the repeal of the partial deduction for contributions that entitle the contributor to college athletic seating is unknown with respect to tax-exempt organizations. For states' and localities' laws that track federal income tax law in determining the amount of an individual's charitable contribution deduction, the repeal of the partial deduction may increase tax revenues. For states' and localities' laws that do not track federal income tax law in determining the amount of an individual's charitable contribution deduction, it is expected to be a neutral change. State policy makers will have to consider whether to encourage gifts of this type by decoupling from the federal change.

VI. Excise Tax on Certain Endowments of Colleges and Universities

[6] I.R.C. § 170(l).

A. Federal Overview

Under the Act, a new excise tax is imposed on an "applicable educational institution" in an amount equal to 1.4% of its net investment income.[7] An "applicable educational institution" is an eligible educational institution (as defined in section 25A(f)(2) (which includes most colleges and universities)) that (i) had at least 500 full-time students during the immediately preceding taxable year; (ii) has more than 50% of its students located in the United States; (iii) is not a state college or university; and (iv) had assets at the end of the immediately preceding taxable year having an aggregate fair market value of at least $500,000 per full-time student. An institution's net investment income is determined under rules similar to those used for determining a private foundation's net investment income under section 4940.

B. Impact of New Law on Tax-Exempt Organizations and State and Local Taxes

The enactment of the new excise tax imposed on certain colleges' and universities' endowment income will increase their federal income tax liability. Unless states or localities enact a similar new excise tax, this new provision is not expected to have any impact on state and local taxation or on states' and localities' coffers. State policy makers will have to consider whether to impose a similar tax on colleges and universities and, if so, whether to vary the federal rules and rate.

[7] I.R.C. § 4968.

SECTION 5: Individual Deductions

Individual Deductions

I. General State Tax Considerations Regarding Individual Income Tax Deductions

A. In General

The provisions in the Act affecting individual income tax deductions raise unique issues for state and local income tax systems that are based on the federal system.

According to the Tax Foundation, 43 states impose individual income taxes.[1] For these states, individual income tax represents a significant part of state and local government revenue, accounting for 24% of state tax collections.[2] Forty-one states tax wage and salary income. Two states – New Hampshire and Tennessee – exclusively tax dividend and interest income. Seven states do not impose an individual income tax. Tennessee is in the process of phasing out its income tax, which is scheduled to be repealed entirely by 2022.

Some states conform to federal tax law by using either federal taxable income ("FTI") or federal adjusted gross income ("FAGI") as their initial income tax base. The changes discussed below may affect states differently, depending on the manner in which the states choose to conform.

B. Federal Adjusted Gross Income States

1. Above the Line Deductions

Some states begin with FAGI in calculating their tax bases ("FAGI states"). So-called "above the line deductions" are those expenses and losses enumerated in section 62 that are deducted in arriving at FAGI. To the extent the Act reduces or eliminates "above the line" deductions, states that continue to use FAGI as their starting point will face revenue impacts.

2. Below the Line Deductions

"Below the line deductions" are those deductions that are not used to calculate FAGI. FAGI states thus may not be affected by Act changes to either the federal standard deduction or federal itemized deductions. Even if states begin with FAGI, however, they may refer to federal provisions in defining their own standard deductions or their own itemized deductions. States also may define personal exemptions with respect to the federal provision, for example, by allowing a deduction for some percentage of the amount allowed by federal law.[3]

C. Federal Taxable Income States

Some states begin with FTI in calculating their tax bases ("FTI states"). FTI states will be affected by any changes to above the line deductions as well as below the line deductions, including the standard deduction, the itemized deductions, and the personal and dependency exemptions.

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[1] https://taxfoundation.org/state-individual-income-tax-rates-brackets-2017/#_ftn1
[2] U.S. Census Bureau, State & Local Government Finance, Fiscal Year 2014, http://www.census.gov/govs/local/.
[3] https://taxfoundation.org/state-individual-income-tax-rates-brackets-2017/#_ftn1

II. Provisions in the Act Addressing Individual Income Tax Deductions

A. Above the line deductions

1. Section 165(d) Limitation on Wagering Loss Deduction

Wagering income is fully included in gross income. Wagering losses are deductible only to the extent that they do not exceed wagering income.

The Act defines losses on wagering transactions to include not only actual wagering losses but also any otherwise allowable deduction incurred in carrying on wagering transactions. Examples may include traveling to or from a casino. The new definition applies to losses occurring after December 15, 2017, and before January 1, 2026.

2. Section 111051 Repeal of deduction for alimony payments (sections 71, 215)

Under prior law, alimony payments were generally includible in gross income of the recipient and were deductible by the payor.

The Act eliminates the above-the-line deduction for alimony payments but does not require the recipient to include the payments in gross income. This provision is effective for divorce decrees, separation agreements, and certain modifications entered into after 2018.

3. Section 217 Deduction for Moving Expenses

Under prior law, employees were allowed to deduct certain unreimbursed moving expenses. If they were reimbursed by their employer, they were not required to include those reimbursements in gross income.

The Act repeals the deduction for unreimbursed moving expenses and the exclusion of reimbursements of such expenses for tax years beginning after December 31, 2017, and before January 1, 2026. However, the deduction or exclusion generally remains available for active duty members of the Armed Forces who move pursuant to a military order and incident to a permanent change of station.

B. Below the Line Deductions.

1. Section 63(c) Standard Deduction

The Act almost doubles the standard deduction effective for tax years beginning after December 31, 2017 and expiring for tax years beginning after December 31, 2025. In 2018, for example, the standard deduction for married individuals filing jointly will increase from $13,000 to $24,000. Concomitant increases are made for other filing statuses. As well as having a dramatic revenue impact, this provision should significantly decrease the number of taxpayers who choose to itemize deductions, which may reduce compliance costs for individual taxpayers and auditing costs for states.

FTI states will experience a concomitant decline in revenue related to this adjustment, as will FAGI states that incorporate the federal standard deduction in computing their own standard deductions.

2. Section 151 Repeal of Deduction for Personal Exemptions

The Act repeals the deduction for personal exemptions effective for tax years beginning after December 31, 2017, and expiring for tax years beginning after December 31, 2025. The personal exemption amount for 2018 would have been $4,510 under prior law.

This change may have a dramatic impact on states and their taxpayers. For taxpayers with dependent children, the loss of the personal exemption will typically outweigh any benefit from the increased standard deduction. Moreover, the more dependents one has, the greater the impact will be. Because most states do not have the equivalent of the federal child tax credit, the overall effect of these changes, which may be relatively neutral at the federal level, will be significant at the state level.

Federal tax credits rarely affect the computation of state taxable income. In this case, however, states should consider the effect on taxpayers of conformity to these provisions without also conforming to the federal child credit. The changes to below the line deductions and the federal child credit are intimately interrelated. Together, they reflect a federal policy decision that taxpayers at some income levels should not be subject to federal income tax. At the state level, state personal exemptions and the standard deduction traditionally have reflected a similar policy decision. Thus, a state with no child tax credit that chooses to eliminate personal exemptions may inadvertently subject lower-income taxpayers to a significant new tax burden. Any policy maker considering these components of the federal package should consider all of them.

3. Changes in the Treatment of Itemized Deductions

a. Section 170 Deduction for Charitable Contributions

The Act increases the FAGI limitation on cash contributions from 50% to 60% for tax years beginning after December 31, 2017, through December 31, 2025.

The new law also repeals the 80% deduction for contributions made for university athletic seat rights post December 31, 2017.

Effective for contributions made after December 31, 2016, the law repeals an exception to the contemporaneous written acknowledgment requirement. The exception had allowed contributions of $250 to be authenticated when the donee organization files the required return.

The state impact of these particular changes with respect to individual taxpayers may not be significant. As noted above, however, the increased standard deduction may reduce the incentive to itemize deductions. If taxpayers do not receive a benefit for itemizing charitable deductions, they may be less likely to make the contribution in the first place, with negative impacts on local charities and educational institutions that rely on such contributions.

b. Section 164 Repeal of SALT Deduction

The Act places a limitation of $10,000 in state and local taxes that individuals may claim as itemized deductions on their individual income tax returns and repeals deductions for other taxes not paid or accrued in a trade or business.

The direct revenue impact of this change may be smaller on the states than it is on the federal revenue because many states require an add-back of the state tax deduction, especially the state income tax deduction. Itemized deductions are available to individual taxpayers not only at the federal level but also in 31 states and the District of Columbia.[4] Most of the states that allow itemized deductions require taxpayers to add back any state income tax deductions claimed on federal tax forms.[5]

The potential indirect impact, however, is of great concern to the states. With full federal deductibility, the federal government was arguably subsidizing state taxes. The new limitations will make the after-tax cost of state taxes much higher, especially but not exclusively for high-income individuals and high-tax states. Many states are considering legislative alternatives, such as allowing certain charitable contributions to be made in lieu of tax payments so as to maximize their citizens' individual income tax deductions and payroll taxes coupled with a credit for employees. These alternatives involve serious policy issues and there are questions about whether they will be acceptable to the Service. These issues are beyond the scope of this memorandum.

c. Section 163(h) Mortgage Interest Deduction Limitation

The Act disallows deductions for interest on personal residence acquisition indebtedness that exceeds $750,000 and is incurred after December 15, 2017. For property acquired before that date a $1,000,000 limitation applies. For tax years beginning after December 31, 2025, the limitation reverts back to $1,000,000 regardless of when the debt was incurred. The provision also disallows deductions for interest on home equity indebtedness for tax years 2018 through 2025.

d. Section 213 Medical Expense Deduction

Under prior law, taxpayers could claim itemized deductions for out-of-pocket medical, dental, and related expenses of the taxpayer, a spouse, or a dependent that were not covered by insurance. This deduction only applied to the extent the expenses exceeded 10% of the taxpayer's adjusted gross income.

For tax years beginning after December 31, 2012, and ending before January 1, 2017, taxpayers who have attained age 65 before the close of the taxable year may deduct medical expenses that exceed 7.5% of their adjusted gross income. The Act extended the 7.5% floor to all taxpayers for tax years beginning after December 31, 2016, and ending before January 1, 2019.

e. Section 165(h) Deduction for Personal Casualty Losses

[4] *See* "State Treatment of Itemized Deductions" Policy Brief, June 2016, Institute on Taxation and Economic Policy, available online at www.itep.org.
[5] *Id*.

The Act repeals the deduction for expenses related to personal non-disaster casualty losses. It applies to losses occurring for tax years beginning after December 31, 2017, and before January 1, 2026. Under the new law, to be deductible casualty losses must be incurred in connection with a trade or business or other activity engaged in for profit or must result from federally-declared disasters.

The partial repeal of the deduction for casualty losses may impact taxpayers' ability to pay when faced with unexpected losses. The impact may be greater in states whose citizens are particularly vulnerable to natural casualties such as flooding, earthquakes, tornadoes, or hurricanes.

f. Section 67 Miscellaneous Itemized Deductions Subject to 2% Floor

The Act repeals the deduction for itemized deductions that were subject to the two percent floor effective for tax years beginning after December 31, 2017, and before January 1, 2026.

Under prior law, taxpayers could deduct miscellaneous expenses including certain unreimbursed employee business expenses; tax preparation fees; expenses paid to produce or collect income; expenses to manage, conserve, or maintain property held for producing income; and expenses to determine, contest, pay, or claim a tax refund. These deductions were deductible to the extent they exceeded 2% of the taxpayer's FAGI.

Each of these deductions has its own policy justifications that should be reviewed by state policy makers. It could be argued, for example, that repealing deductions for expenses for the production of income and unreimbursed employee expenses changes the federal income tax from a net income tax to a gross income tax for certain types of activities. With regard to unreimbursed employee expenses in particular this objection can be overstated because the amount of those expenses relative to wage or salary income is typically small. In fact, having significant unreimbursed expenses may indicate that the individual is likely an independent contractor rather than an employee. Nevertheless, some states may wish to decouple from the repeal of these deductions to preserve net income tax treatment for the production of income outside of a trade or business.

g. Section 68 Overall Limitation on Itemized Deductions

Under prior law, certain itemized expenses otherwise deductible were limited for high income individuals, the so-called "Pease" limitation. Because many itemized deductions are reduced or eliminated, the limitation was deemed unnecessary. Accordingly, the Act repeals the overall limitation on itemized deductions effective for tax years beginning after December 31, 2017, and before January 1, 2026.

h. Revenue impact

The combined effect of the overall limitation on itemized deductions and the changes related to itemized deductions for taxes not paid or accrued in a trade or business, interest on home equity debt, non-disaster casualty losses, certain miscellaneous itemized deductions, and

the increase percentage limit for charitable contributions are expected to raise significant revenue at the federal level.

The revenue impact on conforming states will also be significant. As noted above, however, the net impact is mitigated by the increase of the standard deduction. Also, the limitation on state tax deductions may be less significant if those deductions are already unavailable or limited at the state level.

As with all the Act changes, however, states should not overlook opportunities for increased taxpayer convenience and administrative simplicity of federal conformity.

III. Section 199A Deduction for Qualified Business Income

The Act adds a new provision to the Code, section 199A, which allows certain individuals a deduction for 20% of their qualified business income from a partnership, S corporation, or sole proprietorship. A similar deduction is allowed from gross income of agricultural or horticultural cooperatives. This deduction is novel and complex and is subject to a myriad of special definitions, limitations, and exclusions. A complete treatment of the details of this proposal is beyond the scope of this overview.

The deduction is not allowed in computing FAGI – *i.e.*, it is not an above the line deduction. However, it is available to a taxpayer whether or not the taxpayer itemizes deductions. Accordingly, the provision is most likely to affect FTI states. FAGI states are unlikely to be affected.

There are concerns that the complexity of the provision may create opportunities for unintended tax avoidance. At the federal level, the provision creates incentives for individual taxpayers to earn income through a pass-through entity when possible, which may lead to lower tax collections than expected at the state levels. The effects of Kansas' experimentation with a 0% tax rate on pass-through income may be cited as an example of the potential for similar results under section 199A. States should carefully consider whether to conform to section 199A given the risk of unexpectedly high revenue losses. States should study this provision closely to estimate the local revenue effects as accurately as possible.

SECTION 6: Employee Benefits

Employee Benefits

I. General State Tax Considerations Regarding Employee Benefits

States and localities should consider whether the changes to the federal tax law affecting employee benefits significantly deviate from local policies such that their tax laws should not conform to the changes. For instance, some cities, such as Washington, D.C., New York City, and San Francisco, require employers to maintain transportation programs for their employees, and the repeal of employer deductions for the costs of those programs may frustrate local policy. States and localities should also consider the costs of complexity that arise for taxpayers when their tax systems do not conform to the federal tax system.

Most of the provisions in the Act affecting employee benefits do not raise or cost significant amounts of money over the period from 2018 to 2027 at the federal level and should similarly not raise or cost significant amounts of money at the state and local levels. Therefore, these changes, if adopted at the state or local level, are unlikely to place fiscal stress on state and local governments requiring additional tax revenue or spending cuts. Specific provisions are discussed in more detail below.

II. Provisions in the Act Addressing Employee Benefits

A. Section 162(m) Limitation on Excessive Employee Compensation

Section 162(m) imposes a $1,000,000 cap on the amount of compensation a public company may deduct per covered employee per taxable year. Before the Act, the term "covered employee" included the chief executive officer and three highest paid officers other than the chief executive officer and the chief financial officer. Additionally, the term "compensation" excluded commissions and qualified performance-based compensation.

For tax years beginning after December 31, 2017, the Act alters the definition of "covered employee" to include any individual who served as the chief executive officer or chief financial officer during the taxable year and the next three highest paid officers. Additionally, once a person is a covered employee, the person remains a covered employee for all future years. The Act also repeals the exclusions from "compensation" for commissions and performance-based compensation.

B. Section 83(i) Qualified Equity Grants

The Act added section 83(i) to the Code. This section allows certain employees of a private company that grants stock options or restricted stock units to at least 80% of full-time employees to elect to defer recognition of income beyond the time when the underlying stock is transferred to the employee.

When such an election is made, the income is recognized at the earliest of (i) the date the stock becomes transferable; (ii) the date the employee becomes ineligible for the election; (iii) the date on which any stock of the corporation becomes readily tradable on an established securities market; (iv) the date that is five years after the first date the rights of the employee in

such stock vest; or (v) the date on which the employee revokes the election with respect to the stock.

Employees ineligible to make the election are any individuals who have ever been the chief executive officer and the chief financial officer, any individuals who have owned more than 1% of the employer in the current year or any of the previous ten years, and any individuals who have been among the four highest paid employees in the current year or any of the previous ten years.

The employer receives a deduction at the same time that the employee recognizes income, and the deduction amount equals the employee's income.

Because employees may move from state to state in the course of their employment, a state's decision not to conform to this provision may be particularly problematic for affected employees who move into a non-conforming state from a state with the provision. A non-conforming state must determine when the affected employee realizes income from the stock options or restricted stock units. Further, a state that does conform to the provision may wish to address the recognition of income should the affected employee move from the state. Constitutional issues may arise if the state requires recognition of income upon moving from the state, which action might be considered the imposition of an unconstitutional "exit tax" on the employee.

C. Section 1061 Taxation of Carried Interests

Before the Act, income from carried interests in partnerships generally was characterized as capital income and taxed as long-term capital income if the carried interests were held for more than one year. For tax years beginning after December 31, 2017, the Act denies long-term capital treatment for gains realized by the partnership and passed through to the carried interest holder unless the sold partnership property had been held for more than three years.

D. Section 132(f) Qualified Bicycle Commuting Exclusion

Before the Act, employees could exclude from income up to $20 per month of qualified bicycle commuting expenses reimbursed by their employers. For tax years beginning after December 31, 2017 and before January 1, 2026, the Act repeals the exclusion for employees.

As noted above, this is an area in which many local governments may have particularly strong policy concerns.

E. Section 132(g) Qualified Moving Expense Reimbursement Exclusion and Section 217 Moving Expense Deduction

Before the Act, section 132(g) permitted employees to exclude from income certain moving expenses reimbursed by their employers. For tax years beginning after December 31, 2017 and before January 1, 2026, the Act repeals the exclusion for employees, except for members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. In addition, the Act repeals the section 217 moving expense deduction for unreimbursed expenses for tax years beginning December 31, 2017 and before

January 1, 2026, except for members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station.

F. Section 274 Limitations on Employer's Deduction for Certain Fringe Benefit Expenses

Before the Act, employers could deduct 50% of business-related entertainment expenses. The Act disallows all deductions for entertainment expenses paid or incurred after December 31, 2017.

Before the Act, Employers also could deduct 50% of business-related meal expenses and 100% of amounts for business meals provided through an in-house cafeteria or otherwise on the premises of the employer or to meals provided to employees under section 119 for the convenience of the employer. For amounts paid or incurred after December 31, 2017, the Act extends the 50% limitation on the deductibility of business meals to all such meals. Additionally, for tax years beginning after December 31, 2025, the Act disallows any deduction for the employer's expenses for on-premises meals or meals provided for the convenience of the employer.

Finally, for amounts paid or incurred after December 31, 2017, the Act denies employers' deductions for employee transportation fringe benefits and transportation expenses that are the equivalent of commuting for employees, except as provided for the safety of the employee.

G. Section 74 Employee Achievement Awards

Before the Act, an employee could exclude from income up to $1,600 for certain employee achievement awards and the employer could take a limited deduction for such awards. For amounts paid or incurred after December 31, 2017, the Act provides that such awards given in the form of cash, cash equivalents, gift cards, gift coupons, gift certificates, vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items do not qualify as excludable employee achievement awards.

H. Section 45S Credit for Employer-Paid Family and Medical Leave

For tax years beginning after December 31, 2017 but not beginning after December 31, 2019, the Act introduces a new credit equal to 12.5% of the amount of wages paid in those tax years to qualifying employees during any period in which the employees are on Family and Medical Leave if the rate of payment is at least 50% of the wages normally paid to the employees. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the payment rate exceeds 50%. Credits do not affect taxable income and generally do not pass through to states.

I. Section 4960 Tax on Excess Tax-Exempt Organization Executive Compensation

The Act introduces a 21% tax on compensation in excess of $1,000,000 paid by a tax-exempt organization to any of its five highest-paid employees for the tax year. Once a person is a covered employee, the person remains a covered employee for all subsequent years.

Special federal excise taxes on exempt organizations typically are not incorporated in state and local tax systems unless those jurisdictions adopt their own versions of the tax. Therefore, the inclusion of this tax in the Act does not directly affect state and local tax systems. The taxation or exemption of charitable institutions is fraught with political issues and state and local governments vary widely both in terms of which organizations qualify for exemptions and from which taxes they are exempt.

J. Section 5000A ACA Individual Mandate

Before the Act, the Affordable Care Act ("ACA") contained the "Individual Mandate," which required individuals not covered by a health plan providing minimum essential coverage to pay a penalty with their federal tax return. The Act effectively repeals the Individual Mandate by reducing the penalty to zero for months beginning after December 31, 2018.

The ACA's Individual Mandate does not directly affect state and local tax systems. If this repeal frustrates a jurisdiction's policy of ensuring that its citizens have health care, the jurisdiction should consider whether to alter its tax system to support that policy.

SECTION 7: International

International

I. Introduction

The Act made fundamental and complex changes to the income taxation of multinational taxpayers, including:

- the adoption of a 100% dividends received deduction ("DRD") for certain dividends from foreign corporate subsidiaries;
- a one-time repatriation of earnings and profits accumulated in foreign subsidiaries after 1986, taxed at a rate of 15.5% on cash and cash equivalents and 8% on other assets;
- the current inclusion of "global low-taxed intangible income" of foreign subsidiaries, generally intended to apply when the income deemed attributable to intangibles is taxed at a rate less than 13.125%;
- a new deduction for "foreign derived intangible income;"
- a new alternative minimum tax on a taxpayer's income determined without regard to deductions from "base erosion" payments; and
- new rules for the determination of effectively connected income from the sale of a partnership interest.

These changes and their complex mechanical rules raise numerous conformity and interpretative issues for states and local jurisdictions.

II. 100% DRD for Foreign-Source Dividends

The Act provides that domestic corporate shareholders of 10%-owned foreign corporations will be allowed a 100% DRD for the foreign-source portion of dividends received, effective for distributions made after 2017.[1] Gain from the sale or exchange of stock of a foreign corporation that is treated as a dividend to a domestic corporate shareholder is also eligible for the 100% DRD.[2] The 100% DRD is not available for dividends received by real estate investment trusts or regulated investment companies, for dividends received from passive foreign investment companies, or for hybrid dividends (*i.e.*, an amount received from a controlled foreign corporation ("CFC") the payment of which by the CFC gave rise to a tax benefit to the CFC related to taxes imposed by a foreign country on the CFC). No foreign tax credit or deduction is allowed for any foreign taxes paid (or deemed paid) with respect to a dividend for which the 100% DRD is allowed under section 245A. The 100% DRD is treated as a "special deduction" contained in Part VIII of Subchapter 1B of the Code.

Before 2018, dividends from foreign subsidiaries generally were fully includible in federal taxable income but not in the state income tax base due to the Supreme Court's decision

[1] I.R.C. § 245A.
[2] I.R.C. § 1248(j).

in *Kraft General Foods v. Iowa Department of Revenue*.[3] As a result of *Kraft*, most states have adopted some version of a DRD for dividends from foreign subsidiaries and, in many cases, treated subpart F income as foreign dividends eligible for the same DRD.[4] Some states coordinated their DRD for dividends from foreign subsidiaries with the federal DRD percentages for dividends from domestic subsidiaries,[5] and those percentages also were significantly changed by the Act.[6]

States should confirm whether the 100% DRD results in double deduction of foreign dividends due to conformity with section 245A and a pre-existing state-specific DRD provision for foreign dividends. In addition, states that synchronize their DRD for foreign dividends to the DRD for dividends from domestic corporations to comply with *Kraft* should consider the changes to the DRD rules made by the Act and whether existing state law continues to satisfy the *Kraft* requirements.

III. Repatriation of Foreign Earnings

Before the Act, domestic corporations generally paid U.S. tax on income from foreign sources, but tax on income earned by foreign corporate subsidiaries was deferred until that income was repatriated to the U.S. (with the exception of certain types of income, such as subpart F income, which comprises passive investment income, income arising in related-party transactions, and certain other categories of income). As part of the changes made by the Act, Congress provided for a one-time deemed repatriation of the deferred foreign earnings earned after 1986. The deemed repatriated foreign earnings are taxed at a reduced effective federal tax rates for corporate shareholders: 15.5% for the amount of cash and cash equivalents, and 8% for the remainder.[7]

The deemed repatriation, or transition, tax applies to the last taxable year of each "deferred foreign income corporation" beginning before January 1, 2018 (2017 in the case of calendar year taxpayers and fiscal 2018 in the case of fiscal year taxpayers). Each U.S. shareholder of a "deferred foreign income corporation" is required to include its share of the post-1986 earnings and profits of the deferred foreign income corporation.[8] Under section 965(h), taxpayers may elect to pay the tax liability on the deemed repatriated foreign earnings in installments over eight years.

The includible income is referred to as an increase in subpart F income described in section 952 and is includible in federal income by operation of section 951(a). For state income

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[3] 505 U.S. 71 (1992). In *Kraft General Foods*, the U.S. Supreme Court held that the Iowa statute facially discriminated against foreign commerce in violation of the Foreign Commerce Clause because the statute treated dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries by including the former, but not the latter, in taxable income.

[4] *See e.g.*, D.C. Code Ann. § 47-1803.03(a)(16); 35 ILCS § 5/203(b)(2)(O); Idaho Code 63-3027C; Mich. Comp. Laws Ann. § 206.623(2)(d).

[5] *See e.g.*, 35 ILCS § 5/203(b)(2)(O); 72 Pa. Cons. Stat. § 7401(3)(1)(b).

[6] The Act reduced the DRD for dividends paid by domestic corporations from 80% to 65% (for 20% or more owned dividend payors) and from 70% to 50% (for less than 20% owned dividend payors).

[7] The Code does not actually provide for these lower rates of tax. Instead, in an attempt to achieve these rates, section 965(c) provides a deduction against the deemed repatriated income.

[8] I.R.C. § 965(a).

tax purposes, there may be some doubt as to whether the includible income is, as a technical matter, subpart F income, a deemed dividend, or a foreign dividend equivalent.

In IRS Publication 5292, the Service has indicated that the amount of repatriation income and related deductions will be computed separately and may require the payment of the resulting tax separately.

About one-third of the states are likely to conform automatically to the repatriation transition tax because of their pre-Act provisions taxing either Subpart F or a portion of foreign dividends unless they affirmatively decouple from the federal rules. Most of these states will only tax 25% or less of these amounts. To the extent that states do not include part or all of the repatriation income, the deduction under section 965(c) should be disallowed as necessary to prevent a double benefit.

The Service's announcement that the repatriation tax liability will be computed separately raises the issue of whether any repatriation income should be considered part of federal taxable income to determine the starting point for purposes of computing the state tax base. Florida has taken the position that none of the repatriation exclusion provided for in section 965(c) will be included in the Florida tax base for this reason.[9]

The federal repatriation tax applies to individual shareholders of CFCs as well as to corporate shareholders. However, because the reduced rate of taxation is achieved via a deduction, the rate ends up being higher for individuals. States should consider whether to treat individual shareholders differently from corporate shareholders.

The deemed repatriation of up to 32 years of deferred foreign income, even after reduction by applicable state DRDs and by all or a portion of the deduction under section 965(c), may result in significant state income inclusions that present Constitutional issues, including:

A. How will the *Kraft* prohibition on discrimination against foreign commerce be applied in this setting?

B. May a state include repatriation income attributable to years in which a foreign subsidiary was not in a unitary business relationship with the U.S. taxpayer, or in some cases not owned by the U.S. taxpayer?

C. Must a state provide for apportionment factor representation if a significant bunching of income from a foreign subsidiary is recognized?

IV. Global Intangible Low-Tax Income ("GILTI")

The GILTI provisions are intended to discourage U.S. companies from moving business operations and income-producing intangible assets to low-tax foreign countries (or otherwise shifting income to low tax foreign jurisdictions) and to raise revenues to offset reductions in the federal corporate tax rate and the enactment of the 100% DRD on foreign dividends. In general, domestic corporations must include in federal income certain income of CFCs that exceeds a

[9] Florida TIP 18C01-01(Apr. 27, 2018).

10% return on the CFC's adjusted basis in its tangible depreciable personal property.[10] A 50% deduction for GILTI income is allowed for corporate shareholders, reducing the effective tax rate on such GILTI income to 10.5%;[11] and foreign tax credits generally are allowed to corporate shareholders for 80% of the foreign taxes paid with respect to GILTI income.[12] As a result, for a taxpayer able to use the available foreign tax credits, GILTI will be subject to residual U.S. income tax if the average foreign tax rate imposed on such income is less than 13.125%. Hence, additional U.S. residual tax is due only if the taxpayer's CFCs are subject to relatively low foreign tax rates.[13]

There are a number of issues that state and local jurisdictions may want to consider, including:

A. Should they decouple from the federal rules? The GILTI provisions are intended to implement a federal economic policy. Are state rules needed or desirable to implement that policy or similar state policies?

B. What is the proper tax treatment in their jurisdictions of the GILTI inclusion? Should it be treated the same way that subpart F income is treated?

C. If all or a portion of the GILTI income inclusion is subject to a state-level DRD, then the corresponding deduction in section 250 likely should not be allowed. However, the federal GILTI regime also includes the important element of the federal foreign tax credit and foreign tax credits typically are not allowed by state income tax systems. If all or a portion of the GILTI income inclusion is taken into account for state tax purposes, a proxy for the foreign tax credit element of the federal regime should be considered.

D. The federal GILTI rules apply to individual shareholders as well as to corporate shareholders but individuals do not benefit from a reduced federal rate because the section 250(a)(1)(B) deduction is available only to C corporations. States that decide to adopt the GILTI tax should consider whether to provide a similar deduction for individuals.

Also, like the transition tax, the GILTI tax may result in significant state income inclusions that present Constitutional issues, including:

A. How will the *Kraft* prohibition on discrimination against foreign commerce be applied in this setting?

B. May a state include GILTI income if a foreign subsidiary was not in a unitary business relationship with the U.S. taxpayer?

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[10] I.R.C. § 951A.
[11] I.R.C. § 250(a)(1)(B). The 50% deduction is reduced to 37.5% for taxable years beginning after December 31, 2015.
[12] I.R.C. § 960(d)(1).
[13] It should be noted that the GILTI computations may require allocation of expenses to the includible income of the relevant foreign subsidiaries that could materially affect these figures.

C. Must a state provide for apportionment factor representation if a significant bunching of income from a foreign subsidiary is recognized?

V. Deduction for Foreign-Derived Intangible Income ("FDII")

The FDII deduction is intended to reduce the incentive to move operations abroad by lowering the tax on income from sales by U.S. companies of property or services to foreign buyers. The FDII deduction is a 37.5% deduction for income earned in the U.S. attributed to foreign exploitation of U.S.-held intangibles.[14] This results in an effective tax rate of 13.125% on such income (62.5% of 21%). The FDII deduction is subject to a taxable income limitation and will be reduced from 37.5% to 21.875% after 2025. The amount of "foreign derived intangible income" is the income earned directly by the domestic corporation in excess of a 10% deemed return on the adjusted basis of its tangible depreciable personal property, multiplied by the percentage of its total income attributable to property sold to a non-U.S. person for foreign use or to services provided outside the U.S. The FDII deduction, like the 100% DRD and the GILTI deduction, is a "special deduction" contained in Part VIII of Subchapter 1B of the Code.

States that are "linked" to line 30 (*i.e.*, taxable income before net operating losses and special deductions) of the federal corporate income tax return (Federal Form 1120) are likely to conform automatically to FDII; the same is not necessarily the case with states linked to line 28 (*i.e.*, taxable income) unless they affirmatively choose to decouple. States should consider whether the FDII deduction is consistent with their economic policies.

VI. Base Erosion Anti-Abuse Tax ("BEAT")

The BEAT is a federal alternative minimum tax intended to prevent shifting income to foreign countries and does not increase taxable income. The BEAT applies to C corporations that have average annual gross receipts of at least $500 million for the preceding three tax years and a base erosion percentage (generally deductible payments to foreign affiliates over total deductions) of three percent or higher for the tax year.[15] The BEAT generally imposes a 10% minimum tax (5% in 2018 and 12.5% after 2025) on a taxpayer's income determined without regard to tax deductions arising from "base erosion" payments, including amounts paid by a taxpayer to a related foreign person that are deductible (including interest) or that create depreciable or amortizable asset basis.[16]

This likely will not have an impact on states unless states specifically adopt it because this alternative minimum tax does not affect the computation of federal taxable income.[17] Many states already have an alternative minimum tax and may not feel that it is necessary or desirable to adopt another one. States may conclude that the federal policies that prompted the BEAT do not need further enhancement by similar state provisions.

VII. Sale of Partnership Interest Treated as Effectively Connected Income

[14] I.R.C. § 250(a)(1)(A).
[15] I.R.C. § 59A(e)(1).
[16] I.R.C. § 59A.

The Act added section 864(c)(8) to the Code, which provides that "if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business" to the extent of such gain or loss that would be effectively connected income to the foreign partner if all of the assets of the partnership were sold. This provision was intended to override the result in a Tax Court case[18] and codify the holding of Revenue Ruling 91-32.[19] Section 1446(f) was enacted in tandem with section 864(c)(8) and provides that a transferee of such a partnership interest generally must withhold tax equal to 10% of the amount realized by the transferor. If the transferee fails to withhold, the obligation to collect shifts to the partnership, which is required to withhold from distributions to the transferee partner any amount not withheld by the transferee.

New section 864(c)(8) presents many difficult state income tax issues related to partnerships, but presumably states will treat income or loss recognized from the sale of the partnership interest in the same manner as income or loss attributable to the foreign partner's ownership of the partnership interest that produces it. The state income tax issues include whether a state may tax a nonresident upon its share of income from a partnership, at least some of which is attributable to the taxing state, depending upon whether:

A. The nonresident partner owns a controlling interest in the partnership, a *de minimis* interest, or something in between;

B. The nonresident partner is a general partner or otherwise has management rights in the partnership;

C. The nonresident partner is in a unitary business relationship with the partnership (and if a unitary business relationship is required, the standards for a unitary business relationship with a partnership); and

D. Whether the income is included or excluded for state income tax purposes where the sale of a partnership interest produces income under new section 864(c)(8) but no income is included in federal income because of a treaty with the nonresident partner's home country.

These issues involve Constitutional limitations as well as policy considerations.

[18] *Grecian Magnesite Mining Industrial & Shipping Co., SA v. Commissioner*, 149 T.C. No. 3 (July 13, 2017), *notice of appeal filed* (DC Cir. December 15, 2017).
[19] 1991-1 C.B. 107.