SUTHERLAND

Jeffrey A. Friedman

March 31, 2016

What Would Federal Tax Reform Mean for States?

Urban Institute Forum

WWW.SUTHERLAND.COM

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

All Rights Reserved. This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

Overview of State Income Taxation

SUTHERLAND

- 45 states impose corporate income tax.
  - Only South Dakota and Wyoming do not tax corporate income.
    - 4 states impose gross receipts-type taxes on corporations.
      - Nevada (Commerce Tax); Ohio (CAT Tax); Texas (Margins Tax), and Washington (B&O Tax).

- 41 states impose personal income tax.
  - Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no personal income tax.
  - New Hampshire and Tennessee only tax certain dividend and interest income.

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

What Would Federal Tax Reform Mean for States?

STATE DEPENDENCE ON FEDERAL TAX LAW

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

State Dependence on Federal Tax Law

SUTHERLAND

- States generally begin calculation of state taxable income based on federal taxable income.
  - Corporate income tax: Taxable Income Before NOL (Line 28 of federal Form 1120) or Taxable Income After NOL (Line 30).
  - Personal income tax: Federal Gross Income or Federal Adjusted Gross Income.

Federal Taxable Income (Line 28 or 30)

+ State Addition Modifications

- State Subtraction Modifications

State Tax Base

x State Apportionment Percentage

State Taxable Income

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

State Conformity to Federal Tax Law

SUTHERLAND

- **Floating (or rolling) conformity to the IRC** automatically incorporates any changes to federal law.
  - No corresponding state law changes will be needed to conform to changes that Congress makes to the federal tax law.
  - Approximately half of states with corporate income tax adopt floating conformity to IRC.
- **Static (or fixed) conformity to the IRC** adopts federal law as of a certain date (for example, January 1, 2014) and does not encompass federal law changes enacted after that date.
  - States may be reluctant to automatically adopt federal changes without state legislative review.
  - Approximately half of states with corporate income tax adopt static conformity to IRC.

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

State Dependence on Federal Tax Law

SUTHERLAND

- Taxpayers benefit from consistency between state and federal tax law.
  - Easier to prepare state tax returns.
  - Uniformity for majority of states.
  - Wider body of federal judicial and administrative tax guidance to interpret state tax law.

- States benefit from convenience and ease of administration.
  - Piggyback on federal definitions and calculations.
  - Relieved of auditing federal taxable income starting point due to role of federal tax audits.
  - May use information from IRS audits.

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

SUTHERLAND

What Would Federal Tax Reform Mean for States?

STATE INDEPENDENCE FROM FEDERAL TAX LAW

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

State Independence from Federal Tax Law

SUTHERLAND

- Due to state conformity with federal tax laws, changes at the federal level flow to state level.
- As a result, federal legislation may increase or decrease state tax revenues.
- States may diverge from federal tax law via state "decoupling" modifications.
- Taxpayers must separately track, monitor, and implement state modifications to federal provisions.

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

State Independence from Federal Tax Law

SUTHERLAND

- Case Study: State “Decoupling” from Bonus Depreciation (I.R.C. § 168(k))
  - Congress enacted the Job Creation and Worker Assistance Act of 2002, providing for an accelerated first-year deduction – “bonus depreciation” – for qualifying assets placed into service between Sept. 10, 2001 to 2004.
  - States would incur significant decrease in tax revenue by adopting the federal change.
    - States argued the federal government could afford large deficits.
    - Feds argued stimulus effect would mitigate state revenue decrease.
  - As a result, majority of states reacted by “decoupling” from the federal provisions.
  - Within one year of the federal enactment, 25 states completely decoupled, 4 states limited the deduction, and only 16 states conformed.

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

SUTHERLAND

Common Examples of State Independence from Federal Tax Law

- Net Operating Loss (NOL) Deductions (I.R.C. § 172)
  - Calculation of NOL amount.
  - Carryback and carryforward of NOLs.

- Dividends Received Deductions (I.R.C. § 243)
  - States may disallow DRD for certain REITs.
  - State treatment of foreign dividends.

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

What Would Federal Tax Reform Mean for States?

STATES WITH NO CORPORATE INCOME TAX

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

States With No Corporate Income Tax

SUTHERLAND

- While only South Dakota and Wyoming do not tax corporate income, a few states impose transactional taxes instead.
- Nevada Commerce Tax (effective July 1, 2015)
  - Based on gross revenue.
- Ohio Commercial Activities Tax (CAT)
  - Based on taxable gross receipts, generally without deductions.
- Texas Margin Tax
  - Calculation largely based on total revenue as starting point.
- Washington Business & Occupation Tax (B&O Tax)
  - Based on gross proceeds of sales or value of products manufactured.

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

Questions?

SUTHERLAND

Jeffrey A. Friedman

Sutherland Asbill & Brennan LLP

(202) 383-0718

jeff.friedman@sutherland.com

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP

Connect with us!

SUTHERLAND

The Sutherland SALT Shaker mobile app is now available. Download today from:

- Windows Phone Store
- iTunes App Store
- Google Play
- Amazon Appstore for Android

@Sutherland_SALT

Sutherland SALT Group

© 2016 SUTHERLAND ASBILL & BRENNAN LLP / SUTHERLAND (EUROPE) LLP