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It’s a mad, mad world—compliance complexities upon the horizon

As we all know, U.S. tax reform has radically changed the federal tax landscape. And because of the connection between federal and state income taxes, by extension (**pun intended**) the state tax landscape has also been radically transformed. States generally conform to the Internal Revenue Code (the Code) in one of two ways. Rolling or moving conformity states adopt all changes to the Code as passed by Congress for the tax year in question unless the state passes legislation to decouple from specific provisions. Static or fixed-date conformity states tie to the Code as of a particular date (e.g., December 31, 2017), meaning the state legislature must act to incorporate subsequent federal changes into the state tax law. States are about evenly divided between rolling and static conformity. A small number of states (e.g., Arkansas, California, and Mississippi) adopt only selected Code provisions on a fixed-date or rolling basis. For example, Mississippi adopts the federal deduction for entertainment expenses on a rolling basis but has its own statute allowing a deduction for all business interest. So, without acting at all to address tax reform, Mississippi decouples from section 163(j) but adopts the limits on the deductibility of business-related entertainment expenses.

In the 15 months since the Tax Cuts and Jobs Act was enacted, certain states have responded to tax reform, while other state legislatures have not acted at all. In the states that have responded, the responses have varied considerably. Certain states blindly conformed to all the Tax Cuts and Jobs Act changes. Others decoupled from one or two federal changes or specifically declined to adopt numerous sections of the Tax Cuts and Jobs Act. In addition to state legislatures enacting laws in response to tax reform, certain state taxing authorities have issued policy statements and guidance, for example, clarifying that the state conforms to the federal NOL limitations because of a reference in the state NOL statute to IRC section 172, or indicating that the state considers GILTI to be dividend income eligible for a dividends-received deduction.

It should be highlighted that the work in this area is far from done. Many—if not most—states are still formulating their responses to the Tax Cuts and Jobs Act. Currently, the 2019 state legislative sessions are underway or about to commence in many states, and tax reform will be a key issue for lawmakers to consider (along with sports betting and taxation of marijuana and e-cigarettes). So, between now and the extended due dates of 2018 corporate returns, there will likely be a plethora of additional state tax-reform-related changes to digest and account for. In addition, to date many states have issued scant or no guidance addressing tax reform. It would be great if every state issued comprehensive guidance on tax reform before the time to file 2018 returns, but that’s unlikely to happen and tax professionals will need to ascertain how the state law and federal laws interact.

Because most states have a significant connection to the Code, the federal changes create a myriad of state tax complexities. Thus, it’s fair to say that 2018 state corporate income tax compliance will be more time consuming, more complicated, and more cumbersome. Most importantly, the concept of doing the return the same as last year, or “SALY,” will not be an option.

The following are some important issues to consider when preparing for 2018 compliance in states that conform to all or some of the tax reform changes.

U.S. tax reform item	Potential state tax issues that may arise
Global Intangible Low-Taxed Income (GILTI) and Foreign Derived Intangible Income (FDII) New federal Forms 8992 and 8993	GILTI may or may not be included in the state tax base, depending on a state's IRC conformity and any state-specific exclusions (such as DRDs) that apply to GILTI. Note that GILTI will be included in the federal taxable income starting point in most states, as the income is included on line 4 of IRS Form 1120. In contrast, the section 250 deduction for FDII and GILTI is included on line 29b of the IRS Form 1120 and, thus, will only be included for states that begin the computation of state taxable income with line 30 of IRS Form 1120. If GILTI is included in income, taxpayers will need to consider whether it is business income subject to apportionment or nonbusiness income allocated in full to a single state. If GILTI is included in apportionable income, the question arises as to how GILTI (and any associated section 250 deduction) should be included (or excluded) in computing the taxpayer's apportionment factors. If GILTI is not included in income (e.g., based on IRC conformity or an available subtraction), states may disallow expenses related to GILTI. In separate company filing states and certain states that require combined returns, taxpayers may have to recompute the GILTI/FDII amount to account for differences in filing methodology from the federal return.
Limitations on Interest Expense Deduction under IRC section 163(j) New federal Form 8990	A state may not adopt the new limitations under section 163(j) or may not permit an indefinite carryforward of the disallowed current year expense. In states that have not adopted tax reform, taxpayers may be subject to the pre–tax reform section 163(j), which will require a separate calculation. Taxpayers may need to recompute the section 163(j) interest limitation amount for state purposes to account for differences between federal and state filing methodologies (e.g., unitary combined groups that differ from the federal consolidated group). Additional analysis may be needed in states that do not adopt the federal consolidated return regulations. Consideration must be given to the interplay between the federal limitations on the deductibility of net interest expense and any state-specific related-party expense disallowance provisions, particularly in separate company filing states.
Mandatory Repatriation Revised federal Form 965	The 2018 federal Form 965 must be completed even if a taxpayer's only mandatory repatriation amounts occurred in tax year 2017. States may have differing methods for reporting 2018 Form 965 amounts. Taxpayers may need to recompute the section 965 amounts for state purposes to account for differences between federal and state filing methodologies and consider the impact of any 2018 section 965 income on state apportionment factors.
Net Operating Loss (NOL) Limitations and Unlimited Carryforwards	A state may not adopt the federal 80 percent limitation on state NOLs or the unlimited carryforward. Some states may still permit an NOL carryback. Even in those states that conform to IRC section 172, application of any limitation at the state level could be complicated by the fact that most states provide a state-specific NOL after apportionment.
IRC section 168(k) 100% Expensing/Bonus Depreciation	State conformity to bonus depreciation varies, and certain states conform for some but not all years, requiring multiple depreciation calculations. This is not a new phenomenon specific to tax reform. Most of the states that decoupled from bonus depreciation pre–tax reform have continued to do so post–tax reform.

Nonconforming State Issues

In addition to the considerations in the states that adopt some or all the Tax Cuts and Jobs Act provisions, there will also be significant complexities in states that do not adopt ANY aspects of federal tax reform for 2018. As of this writing, these states are Arkansas, California, Iowa (for tax year 2018), Minnesota, New Hampshire, and Texas. In these nonconforming states, taxpayers may be required to complete new nonconformity schedules to reconcile the difference between the state's law and the current IRC. These schedules may be quite comprehensive and will increase the complexities and time associated with 2018 compliance. There may also be benefits available in these states that taxpayers will want to capture. For example, in a state that still conforms to the Code pre-Tax Cuts and Jobs Act, to the extent the state conformed to the federal deduction for entertainment expenses or the deductions for executive compensation, for state purposes those deductions will not be limited unless and until the state acts to adopt the revised Code.

Conclusion

Not preparing in advance for all of these additional complexities could lead to a painful compliance season. Furthermore, failure to account for the state effects of U.S. tax reform changes could trigger notices, audits, and potential additional tax, penalties, and/or interest. So, it is critical to assess the impact of these changes on your company's state tax compliance process and resources.