Informational hearing: certain corporate income tax effects of P.L. 115-97 ("Tax Cuts and Jobs Act")("TCJA")

Kansas House

Committee on Taxation

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Speaking before the Committee

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Agenda

1. **Kansas taxation of corporate income**
2. Overview of key TCJA provisions for multinational corporations
3. State response to select TCJA provisions: Transition Tax and GILTI

Kansas taxation of corporate income

- **Imposition of tax:** Kansas imposes a corporate income tax on the Kansas taxable income of every corporation doing business within the state or deriving income from sources within the state.
- **Tax base construction:** A corporation's Kansas taxable income is its federal taxable income from Kansas sources, after net operating losses (NOL) and special deductions, as adjusted by Kansas-specific additions and subtractions.
  - "Any reference in this act to the 'federal internal revenue code' shall mean the provisions of the **federal internal revenue code of 1986, and amendments thereto**, and other provisions of the laws of the United States relating to federal income taxes as the same may be or become effective at any time or from time to time for the taxable year." Kan. Stat. Ann. § 79-32,109(a)(1).
    - Thus, **Kansas tax law automatically incorporates federal changes to the IRC definitions of taxable income**, unless existing provisions or new tax law modify such federal chances.

Kansas taxation of corporate income (cont.)

Federal taxable income after net operating loss (NOL) and special deductions

(+) Kansas addition modifications

(–) Kansas subtraction modifications

Pre-apportioned taxable income

(x) Apportionment factor % (based on property, payroll, and sales in Kansas over everywhere)

Apportioned state taxable income

(x) Tax rate 4%

(+) Surtax 3% (over $50,000)

Total Kansas corporate income tax

Common Kansas modifications to taxable income

- **Federal NOL deduction**
  - Add back federal NOL deduction
  - Subtract Kansas NOL (based on Kansas state taxable income, after apportionment)
- **State and local taxes based on or measured by income**
  - Generally deductible for federal income tax purposes
  - Add back to Kansas taxable income
- **Foreign taxes based on or measured by income**
  - Deductible for federal income tax purposes, absent federal foreign tax credit (FTC)
  - Add back to Kansas taxable income
- **Dividends**
  - Domestic: subtract 100% of dividends
  - Foreign: subtract 80% of foreign dividend income included in federal taxable income

Kansas taxation of corporate dividend income

- **Kansas conforms to the federal deduction for dividends received from domestic subsidiaries.**
  - 100% deduction for dividends from a wholly-owned subsidiary.
- **A corporate taxpayer subtracts 80% of dividends “actually received” from corporations incorporated outside of the US which are included in federal taxable income.**
  - Existing Kansas tax law does **not** adequately address new TCJA provisions. Under federal tax reform (to be discussed in the next section), a “new” transition tax is created. Unlike regular dividends, this new category of “deemed” dividends create federal taxable income *without an actual corresponding dividend of cash or property*.

Kansas apportionment of unitary business income

- Kansas apportions multistate business income using a **three-factor apportionment formula containing (i) property, (ii) payroll, and (iii) sales** factors of profitability.
- To capture apportionable business income of a unitary business organized as multiple legal entities, Kansas utilizes a **combined reporting method** for members of a unitary business group.
  - A Kansas unitary business group is determined on a domestic combination basis and foreign group members are excluded. *See*, e.g., *Pioneer Container Corp. v. Beshears*, 684 P.2d 396 (Kan. 1984).
  - Under the domestic combination policy, **only dividend income** from unitary foreign subsidiaries may be included in the Kansas tax base and apportioned**. All other foreign income may not be included in a Kansas domestic combined report**. *Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993).

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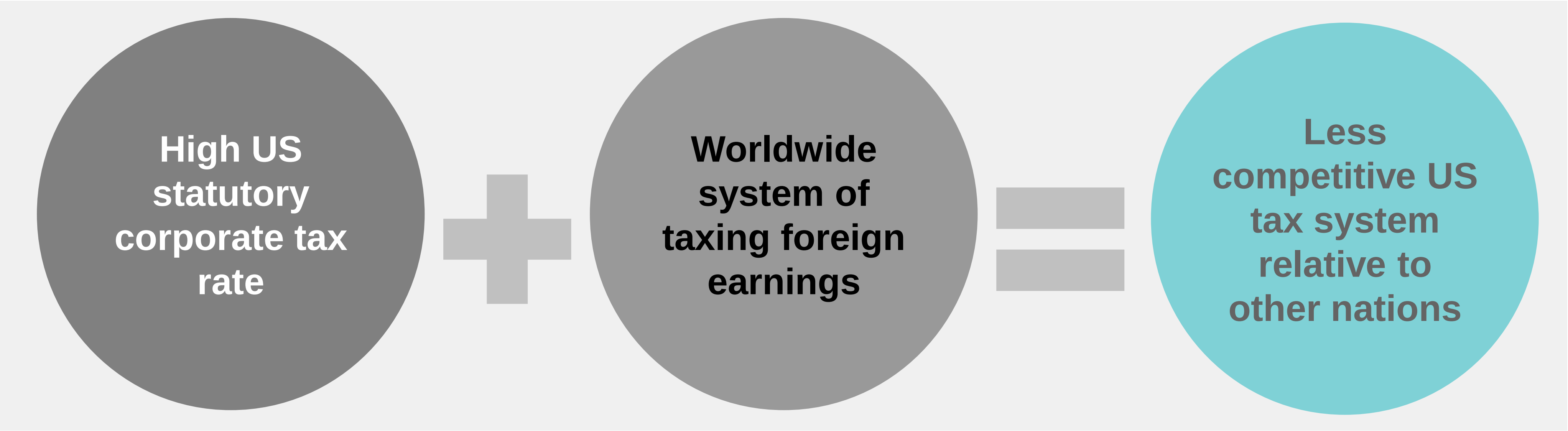
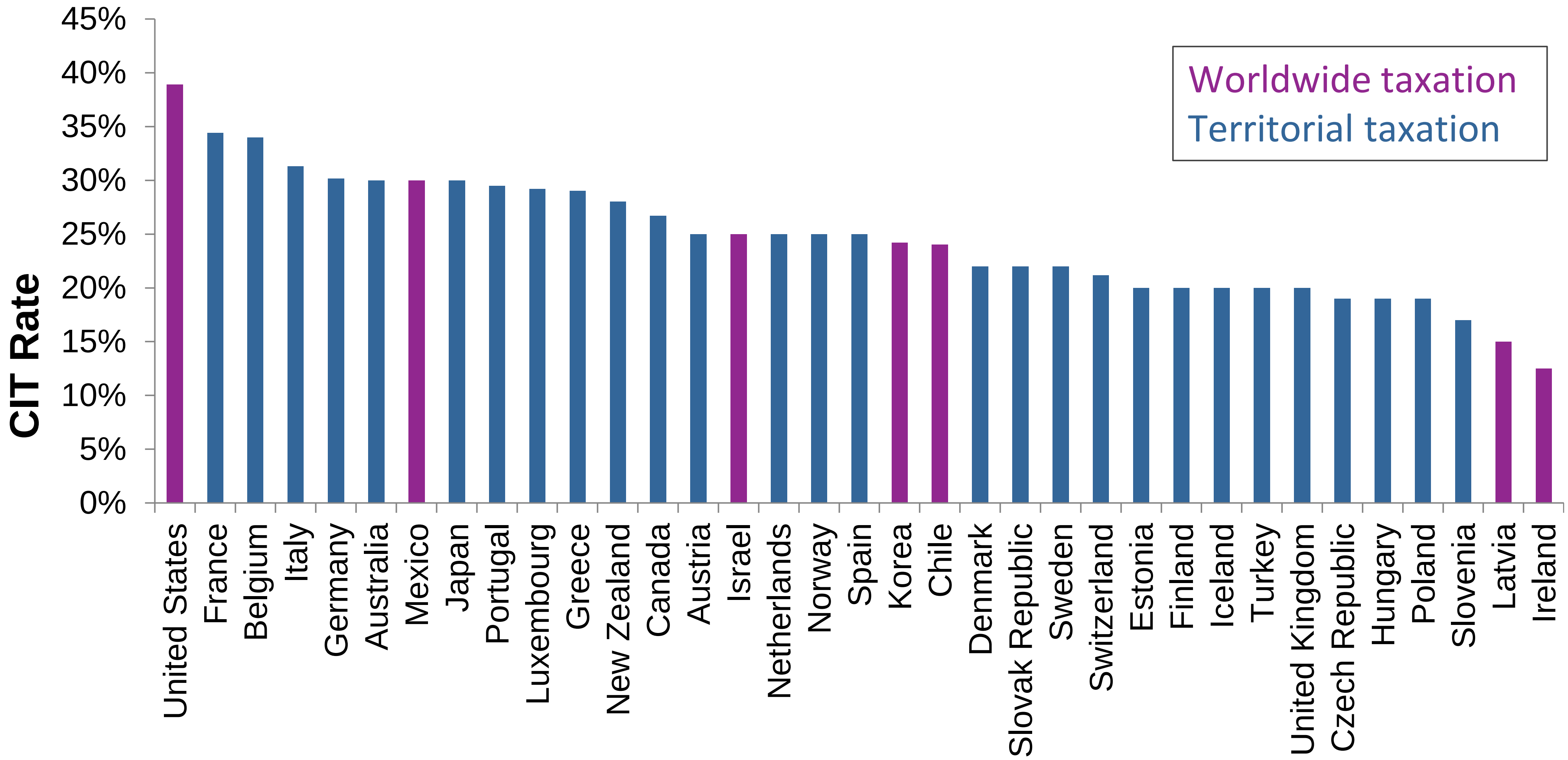
3 State response to select TCJA provisions: Transition Tax and GILTI

Major drivers of tax reform



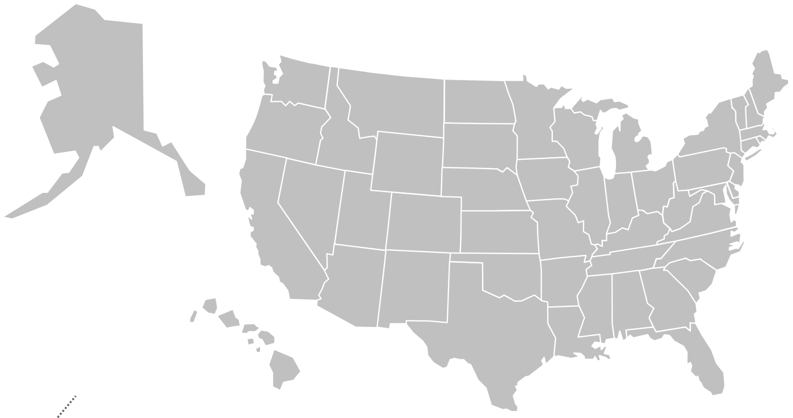
- Lowering the corporate rate and moving to a territorial system seen as generating economic growth, which is hindered by current uncompetitive tax code
- Drivers are not the same as ‘86 Tax Reform Act, which focused on individual rate reduction

Improving the international competitiveness of the 2017 US income tax system



Shift to quasi-territorial federal taxation

Transition Tax



Pre-TCJA (worldwide)

- Worldwide tax base
- Plus/minus:
  - Foreign tax credit
  - Anti-deferral mechanisms (e.g., Subpart F regime)

Post-TCJA (quasi-territorial)

- Arguably continues to be worldwide, but with more exemptions, due to:
  - Anti-deferral mechanisms (e.g., Subpart F regime, including GILTI)
  - Anti-base erosion mechanism (e.g., BEAT)

Key corporate international provisions of the TCJA

- **Mandatory one-time deemed repatriation (Transition Tax) (IRC §965)**
- **Global intangible low-taxed income (GILTI) (IRC §951A)**
- **Deduction for GILTI (IRC §250)**
- Deduction for foreign-derived intangible income (FDII) (IRC §250)
- Foreign dividends received deduction (DRD) (IRC §245A)
- Base erosion and anti-abuse tax (BEAT) (IRC §59A)
- Hybrid arrangements and entities (IRC §267A)

* § or "Section" refers to sections of the Internal Revenue Code (IRC) of 1986, as amended.

Transition Tax

- **A one-time mandatory <u>deemed</u> repatriation of 30 years of accumulated foreign earnings (IRC §965(a)).**
  - Effective in 2017 and may be applicable in 2018.
    - Special federal tax rate of 15.5% for earnings of cash and cash equivalents and 8% for all other earnings (IRC §965(c)).
    - <u>However</u>, no actual cash may be repatriated to the US.
  - In 2017, reported on new federal disclosure created specifically for the one-time deemed repatriation, and is not reported as part of regular federal taxable income.
  - In 2018, reported as a component of Form 1120, Schedule C.
  - To reduce burden of paying tax on 30-years of earnings, the transition tax can be paid in installments over eight years.

Transition Tax (cont.)

- **State considerations:**
  - The federal transition tax was deemed necessary in order to "transition" the US from a worldwide regime (where worldwide income is subject to tax) to a territorial one (only income earned within jurisdictional borders).
  - Kansas already adopts a territorial approach and taxes income from activities occurring within Kansas based on its three-factor apportionment formula. Under existing Kansas law, non-dividend foreign company income cannot be included in a domestic combined report.
  - Several other states have recognized this potential for a significant tax increase by taxing income that has historically never been subject to tax by either:
    - Increasing their state foreign dividend deduction percentage, similar to the federal approach of providing for a reduced tax rate; or
    - Fully exempting transition tax income, consistent with state corporate laws, which generally apply a territorial approach (i.e., states similar to Kansas that exempt most foreign income from corporate taxation).

GILTI income and deduction

- **GILTI is a new annual federal calculation (effective in 2018) intended to ensure a minimum tax is paid on certain worldwide income:**
  - The objective of this new provision is to deter US businesses from transferring operations to low-tax jurisdictions.
  - Corresponding federal provision "encourages" on-shoring of operations by providing beneficial tax rate.
  - <u>GILTI is a minimum tax:</u>
    - It is <u>not</u> economic income resulting from a sale of a good, the provision of a service, or the use of an intangible.
    - It is <u>not</u> US income
    - It <u>is</u> a minimum tax on income earned in low tax foreign countries that does not actually come back to the US

GILTI income and deduction (cont.)

- **State considerations**
  - The TCJA was designed to favor US employment and investment. States, however, are limited by the Constitution's Commerce Clause and are not permitted to favor domestic commerce over foreign commerce.
  - GILTI is foreign-source income and presumably should be excluded from taxation in a water's-edge unitary combined return, like Kansas.
    - Such approach is consistent with Kansas Supreme Court precedent exempting foreign non-dividend income from Kansas corporate taxation.
  - Kansas, like many states, has provisions in its law that currently provide the Dept. of Revenue the tools to audit activities aimed purely at reducing a business' state tax burden.

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State conformity to provisions of the TCJA

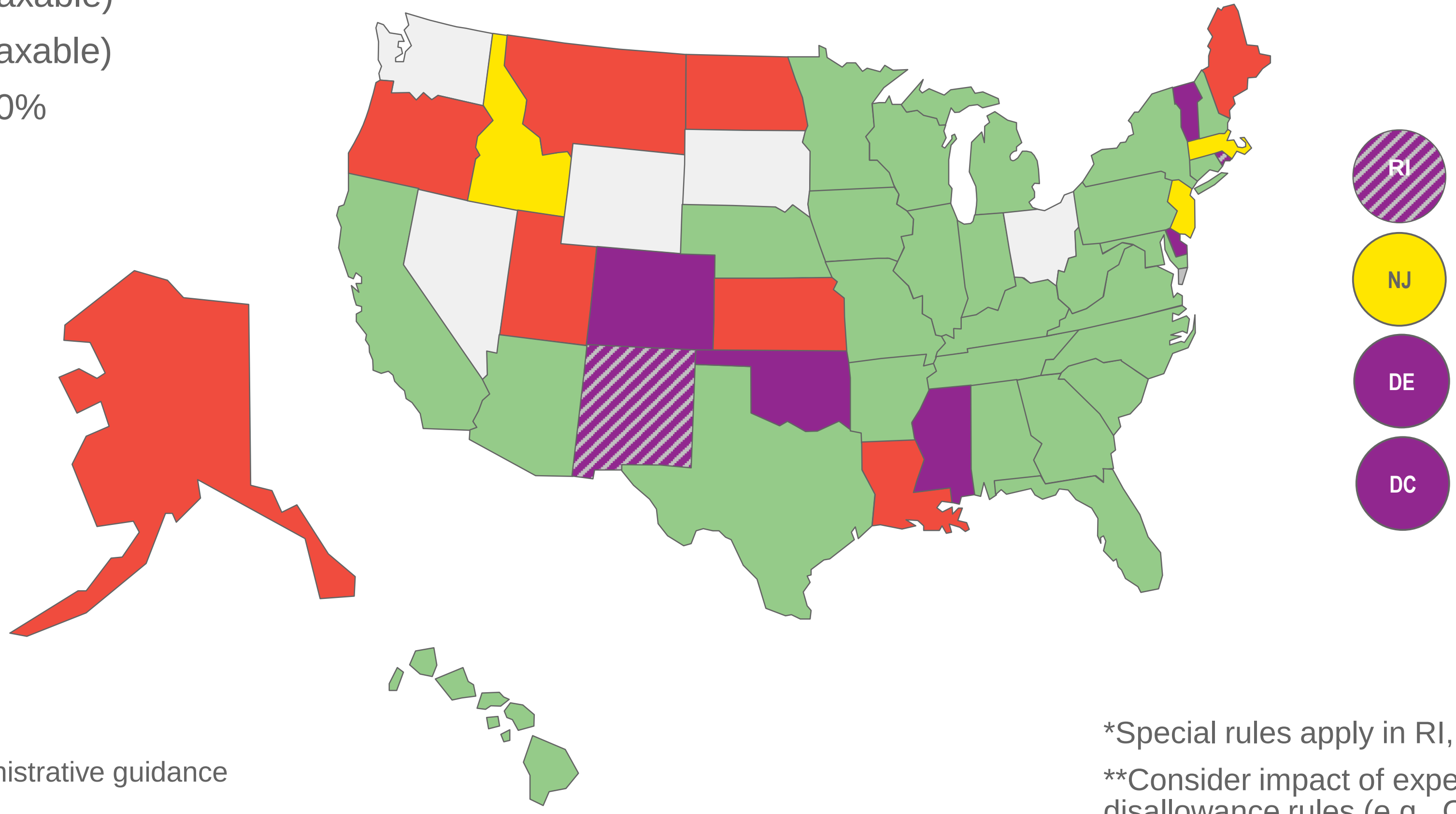
- **Impact of the TCJA on corporations:**
  - A **federal** tax cut of about 10%.
  - A **Kansas** tax increase of about 11%
    - COST/ EY study *“The Impact of Federal Tax Reform on State Corporate Income Taxes”* (based on 2018 update and pre-federal tax reform linkage to IRC).

- **This outcome is inadvertent and may be arbitrary:**
  - States that conform to the TCJA – either automatically or by updating its IRC conformity date – and take <u>no</u> further action, will incorporate federal corporate base-broadening measures.
  - States do <u>not</u> conform to federal tax rate.
  - Therefore, if Kansas does <u>NOT</u> decouple from the TCJA it would be a <u>significant</u> state tax increase on businesses.

State taxation of IRC §965 Transition Tax repatriation from wholly-owned foreign subsidiary (2017 tax year)

Key

- Not taxable. Pre-TCJA fixed or selective conformity or full modification
- > 80% modification (partially taxable)
- ≤ 80% modification (partially taxable)
- No modification to federal (100% taxable)
- No corporate income tax



*Special rules apply in RI, NM

**Consider impact of expense disallowance rules (e.g., CT versus MA)

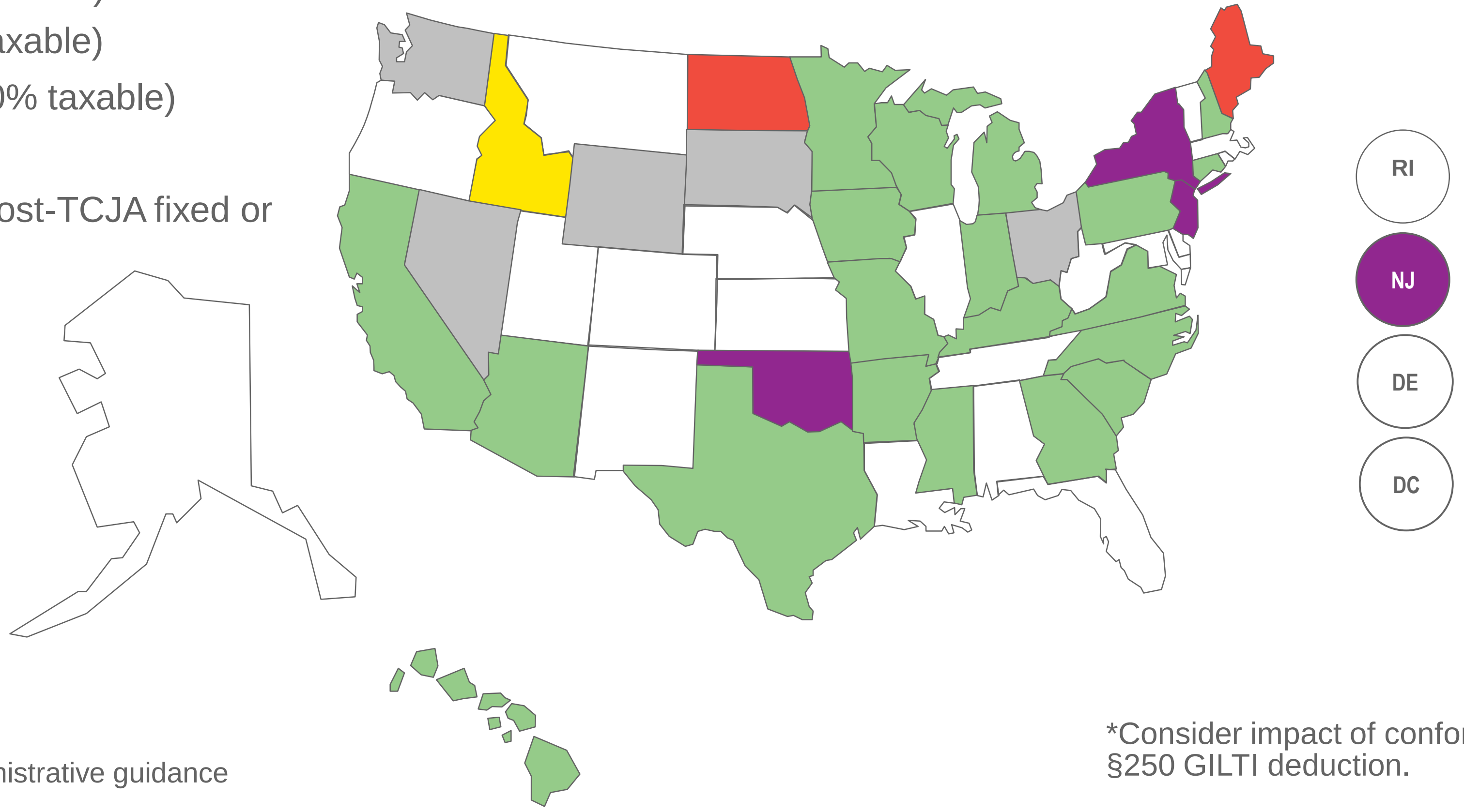
Source: EY analysis of state tax law and administrative guidance

As of January 1, 2019

State taxation of IRC §951A GILTI from wholly-owned foreign subsidiary (2018 tax year)

Key

- Not taxable. Pre-TCJA fixed or selective conformity or explicit state response providing a full modification
- > 80% modification (partially taxable)
- ≤ 80% modification (partially taxable)
- No modification to federal (100% taxable)
- No corporate income tax
- No explicit state response in post-TCJA fixed or rolling conformity state



*Consider impact of conformity to IRC §250 GILTI deduction.

Source: EY analysis of state tax law and administrative guidance

As of January 1, 2019

Questions

Appendix: Additional state tax considerations of IRC §965 Transition Tax and GILTI

Constitutional limitations on state taxation of foreign commerce

- **Separate reporting states:** See *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992). A separate reporting state may not tax dividends from a controlled foreign corporation if it does not tax dividends from a controlled domestic corporation.
  - The governing principle was not discrimination against dividends, *per se*, but against foreign commerce. Thus, under the *Kraft* precedent, the state taxation of GILTI would be similarly prohibited in separate reporting states.

- **Combined reporting states:** The fact pattern may be viewed as different for taxing foreign subsidiary dividends (and possibly GILTI) in combined reporting states (such as Kansas), as these states include the income/apportionment factors of all includible unitary corporations in the calculation of taxable income.
  - Nonetheless, the taxation of GILTI in combined reporting states likely violates Commerce Clause limitations unless foreign "factor representation" is allowed.
  - See contra: *E.I. du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Maine 1996) and *Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993).
    - As earlier mentioned, Kansas uniquely taxes foreign dividends as a rate higher than domestic dividends in contract to the *Kraft* precedent.

IRC §965 Transition Tax state income tax considerations

- **Will states adopt the IRC §965(c) tax rate reduction?**
- **Apportionment and factor representation issues.**
  - Over the 30 years encompassed in the mandatory “deemed” dividends period, a US Corporation’s footprint in any given state may have changed significantly, and the state’s filing method, method of apportionment (3FF, SSF) and tax rate may have changed significantly.
- **Earnings and profits (and deficits) are netted at the federal consolidated group level.** This presents unique issues in separate entity states and states where the filing group differs from federal.
- **If all mandatory deemed-repatriated income is excluded from the state tax base, will the state disallow expenses associated with the income?**
- **Will the states follow the federal elections, such as the IRC §965(h) election to pay Transition Tax liability in installments over 8 years?**

GILTI income and deduction

- **GILTI is a new annual federal calculation intended to ensure a minimum tax is paid on worldwide income and is effective in 2018.**
- **Essential components of the federal GILTI calculation:**
  - **IRC §951A:** Includes all global income earned by the taxpayer’s foreign subsidiaries in excess of a certain return. Makes assumption on how much is intangible based on a set rate of return on tangible assets.
  - **IRC §250(a)(1)(B)):** Provides an offsetting deduction to lower the effective tax rate.
  - **Foreign Tax Credits**: Finally, a credit is provided for 80% of taxes paid to foreign jurisdictions on the GILTI income, which ensures only low-taxed foreign income is subject to federal taxation. Generally, a taxpayer will not be subject to residual US tax if the average foreign tax rate imposed on such income is at least 13.125% (increased to 16.406% in 2026).

State versus federal impact of GILTI

- **Global:** Yes, the starting point of the GILTI computation is all of the global income earned by the taxpayer's controlled foreign subsidiaries.
- **Limited to intangibles:** This is a misnomer – GILTI includes income from services, digital products, financial services, a sizable portion of tangible property sales, and intangibles.
- **Low-taxed:** No, the states do not conform to the (80%) foreign tax credit allowed for federal tax purposes to offset the GILTI income. In addition, many of the states may not conform to IRC Section 250 that allows for a 50% deduction for GILTI income.
- **Offset by corporate tax rate cuts**: No, states do not conform to federal corporate tax rate cuts (Congress is raising $324 billion over 10 years from the international tax provisions to help pay for $654 billion in business tax cuts).
- **Favor domestic over foreign commerce:** No, the states are limited by the Constitution's Commerce Clause.

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