

The COVID Hangover

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Agenda

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- State of the States
 - Post-TCJA and CARES Act considerations
 - The states were busy in 2021
 - Federal tax reform and the states
 - Considerations and planning
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STATE OF THE STATES



The American Rescue Plan Act and state and local finances

The American Rescue Plan Act (ARPA) of 2021, signed March 11, 2021

- ARPA allocates approximately \$350 billion (\$195.3B specifically to states and D.C.) in emergency funding for state and local governments for their response to the pandemic, to offset revenue losses, strengthen economic recovery and provide premium pay for essential workers
- States must obligate funds by Dec. 31, 2024 and spend the funds by Dec. 31, 2026
- *“A state or territory **shall not use the funds provided** under this section or transferred pursuant to section 603(c)(4) to either directly or indirectly offset a reduction in the net tax revenue of such State or territory resulting from a change in law, regulation, or administrative interpretation during the covered period that reduces any tax (by providing for a reduction in a rate, a rebate, a deduction, a credit, or otherwise) or delays the imposition of any tax or tax increase.”*

The American Rescue Plan Act and state and local finances

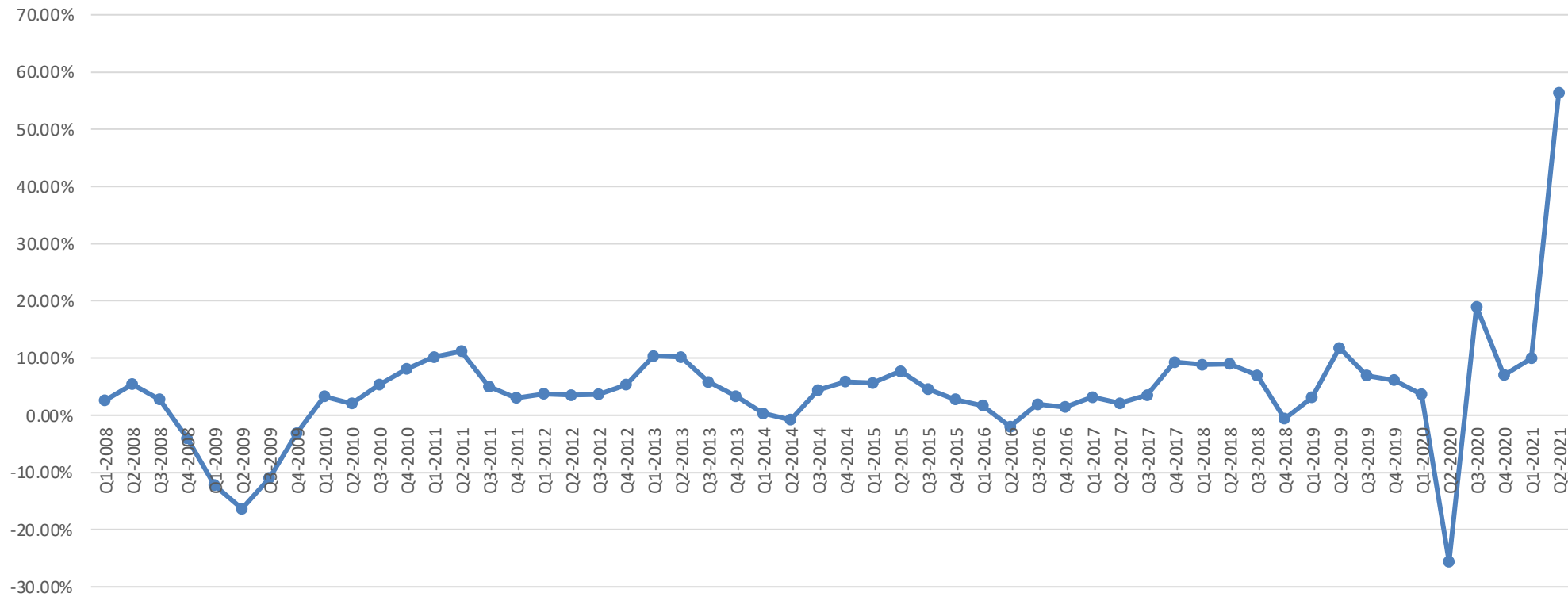
ARPA litigation

- States have challenged the prohibition on using ARPA funds to cut taxes. Several lawsuits filed in various federal courts seeking to enjoin the provision
 - State arguments have included vagueness of language, federal overreach
 - Treasury has argued limitation is within Congress' spending power
- *Kentucky v. Yellen* (E.D. Ky).
 - Sept. 24, 2021: Federal district judge rules in favor of Kentucky and Tennessee finding the tax restriction provision unconstitutional
- Other litigation occurring in at least five other federal circuits
 - Arizona District Court ruled against Arizona, appeal ongoing in 9th Circuit

Pandemic recovery tax collections

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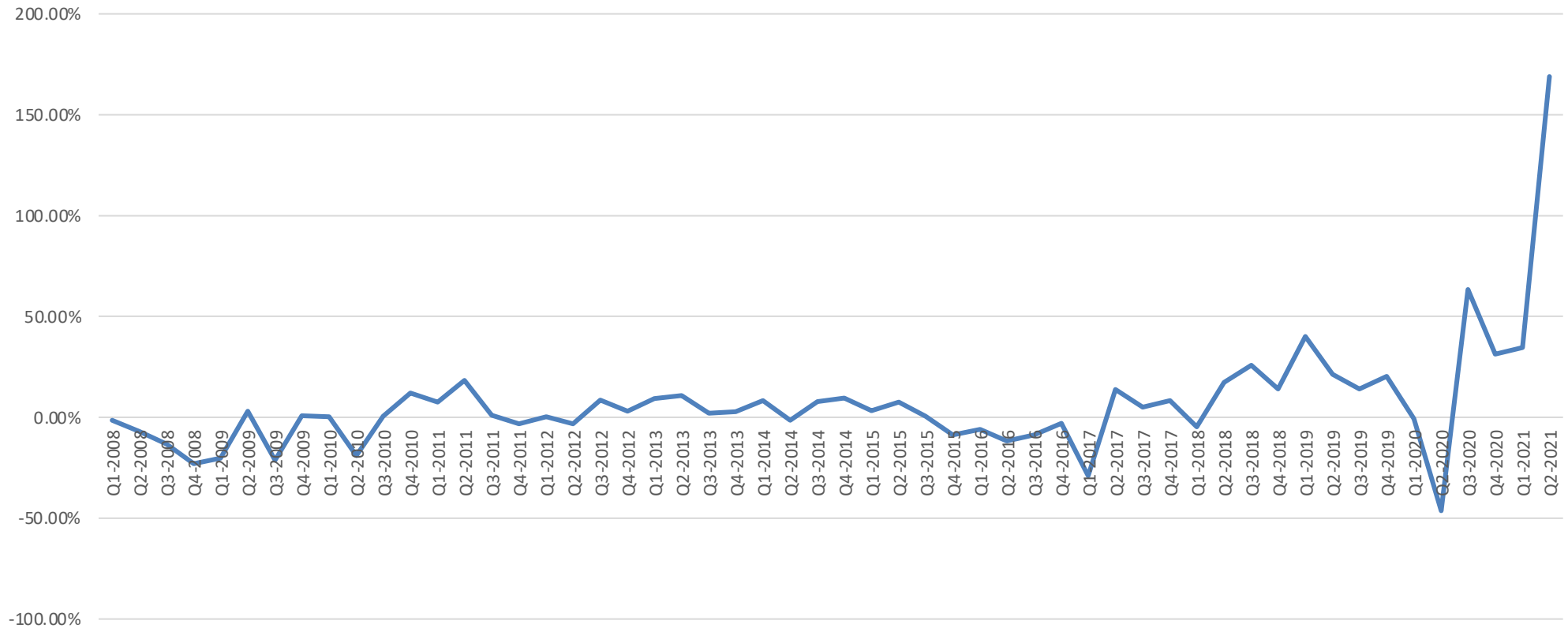
Year over year quarterly percentage change in total state tax collections – Q1 2008 through Q2 2021



Pandemic recovery tax collections

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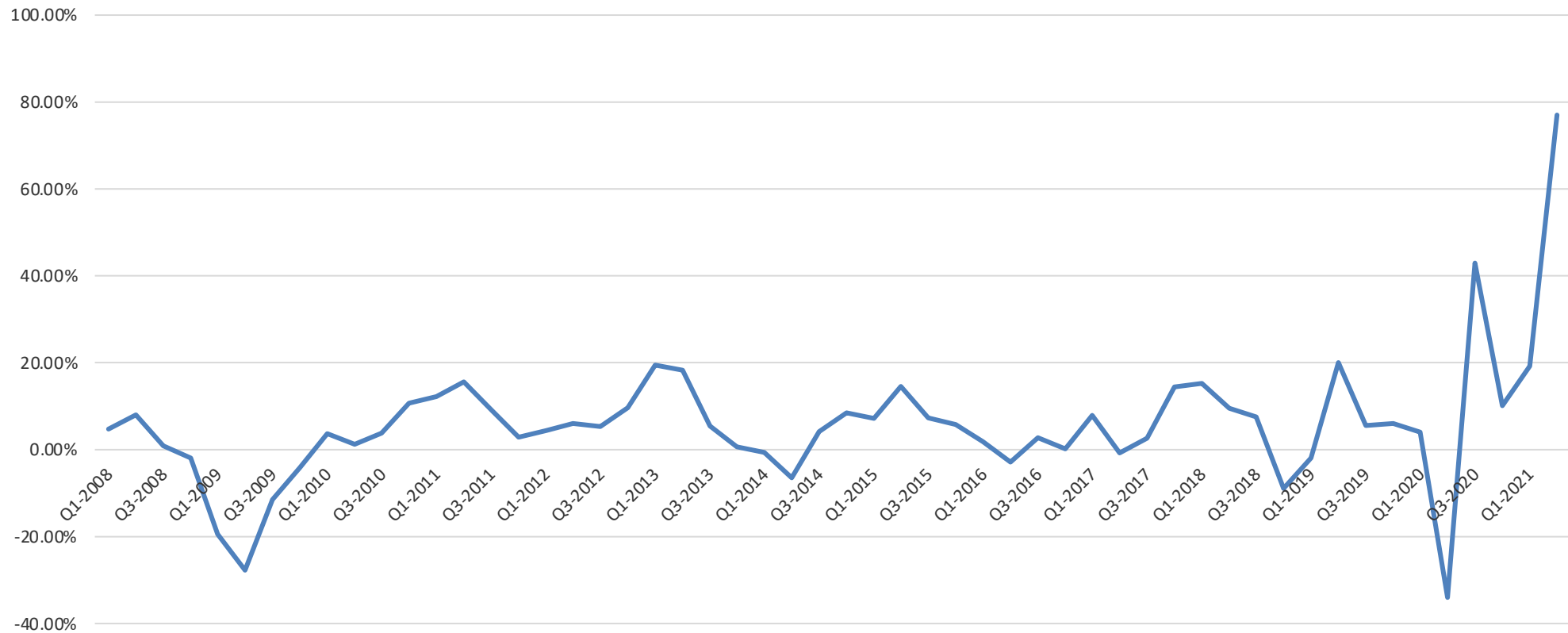
Year over year quarterly percentage change in total state corporate income tax collections – Q1 2008 through Q2 2021



Pandemic recovery tax collections

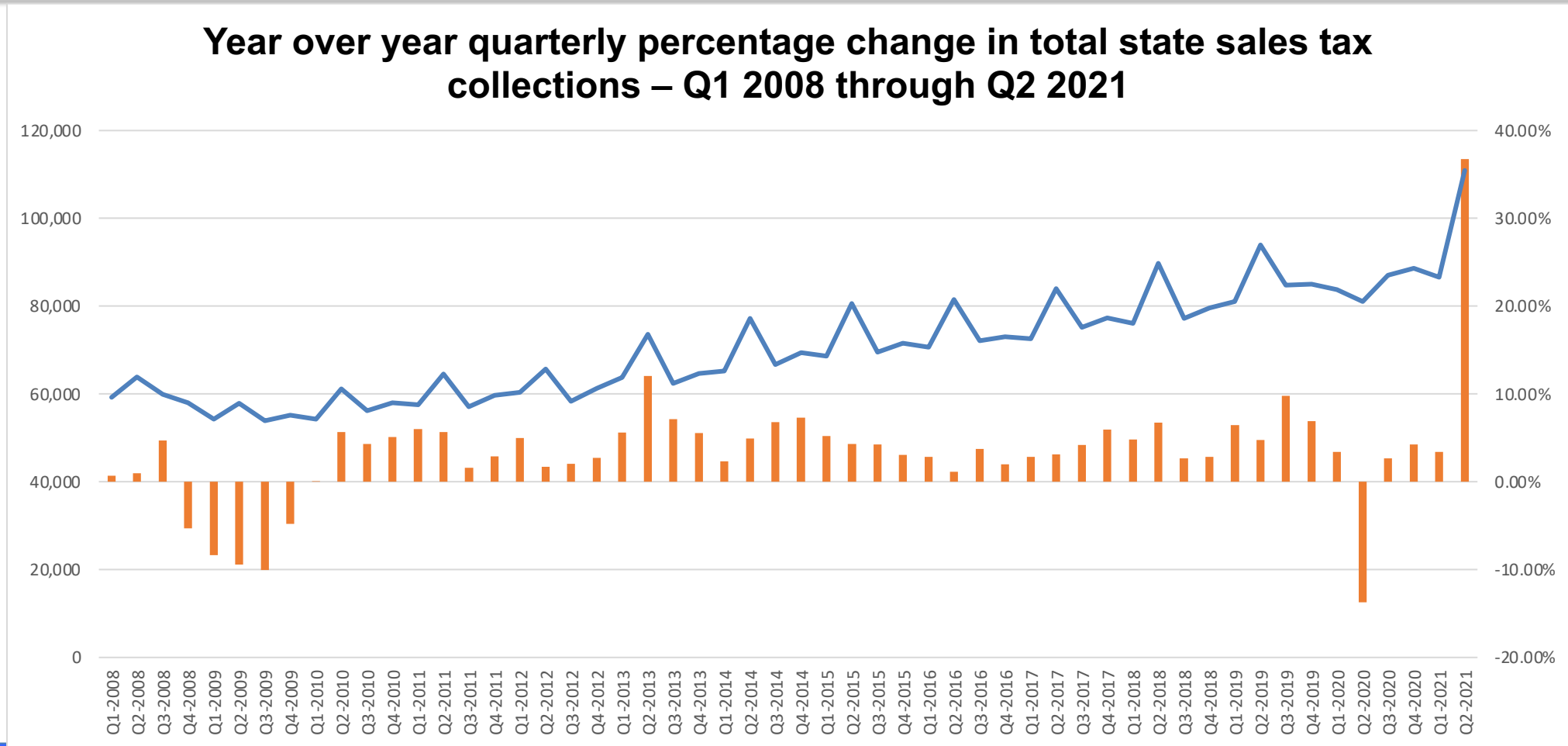
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Year-over-year quarterly percentage change of individual income tax collections - Q1 2008 through Q2 2021



Pandemic recovery tax collections

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Key Takeaways

- Regardless of ARPA litigation, states have funds to use for a variety of purposes, if not also tax cuts
 - Personal income taxes and sales and use taxes driving tax collections
 - Sin taxes (alcohol, cigarette, vapor and marijuana taxes) continue to supplement base
- State and local tax collections mostly rebounded through calendar Q2 2021, exceeding the trend if the pandemic had not occurred. States continue to see positive growth and sustained collections into Q3
- State legislative actions bolstered by revenues in 2021
 - Few new nexus actions
 - Little sales tax base expansion
 - Many corporate and individual rate cuts, although mostly minor
- Short-term looks good, how long will it last?

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POST-TCJA AND CARES ACT CONSIDERATIONS




The CARES Act

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Signed into law on March 27, 2020

Largest stimulus package in US history (est. \$2.2 trillion)

Includes several taxpayer-favorable changes to core federal tax provisions enacted or revised by the TCJA

- NOL provisions under Section 172
 - Business interest limitation provisions of Section 163(j)
 - Bonus depreciation provisions of Section 168(k)
 - Excess business loss limitation provisions under Section 461(l), and
 - Corporate alternative minimum tax (AMT) provisions under Section 53(e)
- 

Net operating losses: Post-TCJA

NOLs post TCJA

- 80% limitation (determined without regard to the deduction) on the deductibility of loss carryforwards arising in taxable years beginning after Dec. 31, 2017
- Elimination of NOL carrybacks
- Unlimited NOL carryforwards for losses arising in taxable years beginning after Dec. 31, 2017

Net operating losses: Post-CARES Act

NOLs Post CARES Act:

- Elimination of the 80% Limitation
- “The Temporary Repeal of Taxable Income Limitation”
- Applicable to taxable years beginning before Jan. 1, 2021
- NOLs from taxable years beginning after Dec. 31, 2017 that are carried forward to taxable years beginning after Dec. 31, 2020 will be subject to the 80% limitation that was enacted as part of TCJA

Reinstatement of NOL Carrybacks:

- 5-year carryback period for NOLs arising in 2018, 2019, and 2020 (taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2021)

Net operating losses: Post-CARES Act

State deviation from Federal NOL rules

- Line 30 v. Line 28:
 - Does the state specifically adopt the use federal NOLS deduction by use of line 30 as a starting point?
 - Is the federal NOL required to be added back – separate state NOL computation?
 - Is there a separate NOL computation for those states that start with line 28?
- NOL Carryback provisions - Issues:
 - NOL carrybacks could impact GILTI/FDII deduction
 - Can a NOL carryback open state statutes of limitations?
 - Are you required to file an amended state return because you filed an amended federal return?

Interest Expense Limitation: Post-CARES Act

Post-TCJA

- Limits deduction for business interest expense to the sum of:
 - Allowable Interest Expense Deduction = Adjusted Taxable Income (ATI) * 30% + Business Interest Income + Floor Plan Financing Interest Expense

Post-CARES Act: New Section 163(j)(10)

- In the case of any taxable year beginning in 2019 or 2020, the business interest expense limitation amount is increased from 30% of ATI to 50% of ATI
- Taxpayers may elect not to have Section 163(j)(10) apply, retaining the application of the 30% ATI limitation
- Permits taxpayers to elect to use 2019 ATI for taxable years beginning in 2020

International: GILTI and FDII

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International changes post-TCJA

- Global Intangible Low-Taxed Income (GILTI) - Effective for taxable years beginning after Dec. 31, 2017, Section 951A added by the TCJA imposes a 10.5% tax on a U.S. shareholder's share of a CFC's GILTI
- GILTI deduction of 50% provided by Section 250(a)(1)(B) to arrive at a 10.5% effective federal tax rate on GILTI.
- A separate Foreign-Derived Intangible Income (FDII) deduction is provided by IRC § 250(a)(1)(A) to encourage "on-shore" (US) production for sales off-shore.
- Section 250 deductions are special deductions for C corporations inapplicable to individuals and pass-through entities.
- Understand the federal pass-through entity reporting of GILTI
- GILTI High Tax Exclusion election

International: GILTI and FDII

State reactions

- Most provide a GILTI or “net GILTI” subtraction; may only be a partial subtraction.
- Some conform to Sections 951A and 250 (NJ, NH, NYC, VT)
- Watch out for the 2018 “gap” year (AZ, NYS)
- Some states are still silent! May need to fit into a state’s foreign-source DRD or subpart F subtraction
- Sales factor treatment and sourcing

Consider impact from federal NOL carrybacks on state-allowed IRC § 250 deductions

Advance planning is necessary for subsequent year distributions of federal/GILTI PTI

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THE STATES WERE BUSY IN 2021



State conformity and a changing landscape

Continuing conformity decisions on TCJA/CARES Act changes

- **Alabama** specified treatment for calculating Section 163(j) limitations and decoupling from GILTI income inclusions retroactive to tax years beginning after 12/31/17
- **Colorado** legislation to allow certain CARES Act state subtractions (H.B. 21-1002)
- **Kansas** 100% subtraction modification for GILTI and Section 163(j) disallowed interest, unlimited NOL carryforwards (S.B. 50)
- **Illinois** addbacks for the 50% GILTI deduction, Section 245A and Section 243(e); Section 1248 dividends are not considered dividends for IL purposes; 100% bonus depreciation decoupling (S.B. 2017)
- **Iowa** retroactive Section 168(k) conformity, continued decoupling from Section 163(j) (S.F. 619)
- **Maine** legislation to generally incorporate changes enacted by the CARES Act (L.D. 220)
- Proposed **California** inclusion of 40% deemed repatriation, 50% GILTI (A.B. 71, moved to inactive file, 6/3/21)

Corporate rate and apportionment changes

Corporate rate increase proposals reflect debate at the federal level

- **New York** budget increases the corporate franchise tax rate to 7.25% from 6.5% for tax years beginning on or after 1/1/21 and before 1/1/24 (for taxpayers with a business income base greater than \$5 million)
- **Connecticut** budget implementing bill extends the 10% corporate surcharge through 2022
- **Illinois**, after failing to increase rates, limits NOLs to \$100k for 3 years ending on or after 12/31/21
- Counter-balanced by corporate rate reductions (e.g., **Idaho** H.B. 380, **Louisiana** H.B. 292 - creates ballot measure, **Nebraska** L.B. 432, **New Hampshire** H.B. 2, **Oklahoma** H.B. 2960, and proposed in **NC** budget)

Continuing trend to single sales factor and market-based sourcing

- **Alabama** H.B. 170, enacted 2/12/21, adopts single sales factor apportionment and repeals the ‘throwback rule’ for sales of TPP, both effective for tax years beginning on or after 1/1/21
- **Montana** S.B. 376, enacted 5/11/21, double-weighted sales factor effective for tax years beginning after 6/30/21
- **West Virginia** H.B. 2026, enacted 4/9/21, adopts single-sales factor apportionment and market-based sourcing while repealing the throwout rule effective for tax years beginning on or after 1/1/22

No new combined reporting states in 2021 (study underway in VA, taxpayer information reporting)

- **Colorado** “tax haven” list (plus Finnigan apportionment) signed by Governor, 6/23 (H.B. 1311)

Next steps on nexus

Post-*Wayfair* standard for income/franchise taxes?

- MTC model factor presence nexus statute and state adoption
 - Maine H.P. 891, effective 2022, \$500k sales, \$250k property or payroll (or 25% of property, payroll, or sales)
- State “economic nexus” case law and regulations
- State “doing business” statutes and post-*Wayfair* constitutional limitations

Future of P.L. 86-272

- MTC’s revised policy statement adopted at its Annual Meeting on August 4, 2021
- “As a general rule, when a business interacts with a customer via the business’s website or app, the business engages in a business activity within the customer’s state”

Expiration of COVID-19 emergency policies impacting nexus

Practical approaches to ‘doing business’ and nexus questions

SALT deduction limitation workarounds

Pass-through entity tax workarounds

- \$10,000 state and local tax (SALT) deduction limitation on individuals
 - Federal tax reform could eliminate, temporary repeal , or increase the cap
- Flood gates open in 2021
 - 13+ state legislatures approve pass-through entity workarounds in 2021
 - 20+ states anticipated to provide a workaround beginning in 2022
- State workarounds may be extremely beneficial to small and mid-sized professional service firms, but multistate activities and partners may complicate analysis
- Federal cap and issue update

States with adopted or proposed pass-through entity (PTE) level tax

As of October 8, 2021



- States that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted:
[AL](#), [AR](#)¹, [AZ](#)², [CO](#)¹, [CT](#)², [GA](#)¹, [ID](#), [IL](#), [LA](#), [MD](#), [MN](#), [NJ](#), [NY](#), [OK](#), [OR](#)², [RI](#), [SC](#), [WI](#)
¹ Effective in 2022 or later
² Mandatory
- States with proposed PTE tax bills:
MA – [H. 4009](#), vetoed by governor
MI – [HB 5376](#), first reading
NC – [S. 105](#), in reconciliation
OH – [SB 246](#), in committee
PA – [HB 1709](#), in committee
- No owner-level personal income tax on PTE income

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FEDERAL TAX REFORM AND THE STATES



The Made in America Tax Plan - Overview

The Made in America Tax Plan

- **Purpose:** Raise corporate income taxes to pay for its “American Jobs Plan” related to infrastructure and other spending programs

The key proposed Corporate Income Tax provisions:

- Raise the corporate income tax rate to 28 percent
- Raise the GILTI tax rate to 21 percent
 - Expand GILTI tax by eliminating QBAI and calculating GILTI based on a country-by-country basis
- Enact a 15 percent minimum tax on book income of large companies
- Replace BEAT with SHIELD
- Repeal FDII and replace it with expanded R & D investment incentives
- Tighten anti-inversion rules
- Additional limitation on interest expense (Section 163n)
- Eliminate tax preferences for fossil fuels; provide incentives for clean energy production
- Increase funding and ramp up corporate tax audit enforcement

Major state corporate tax impact of federal tax reform (House Ways & Means markup)

Overview: State conformity

- The threshold question regarding all federal changes is how a state conforms to the Internal Revenue Code.
 - Rolling conformity = Immediate conformity, unless there are specific decoupling provisions
 - Fixed-date conformity
 - Code-specific conformity
- Timing of state legislative reactions

Increase corporate tax rate to 26.5%

- Limited impact
- Increased deduction for federal income tax paid in a handful of states (e.g., AL and MO)

Research and experimental expenditures

- Impact will depend on IRC conformity
- Fixed-date conformity could still require capitalization of R&D

Major state corporate tax impact of federal tax reform (House Ways & Means markup)

Interest deduction limitation

- States with rolling conformity will conform to Sections 163(n) and 163(o).
 - Prior decoupling specific to Section 163(j) does not mean that the state decouples from the new provisions.
 - However, decoupling from or modifications to Section 163(j) could result in a different state tax impact (taxpayers federally take the *lesser* deduction amount allowed under either Sections 163(j) or 163(n)).
- States that are fixed-date conformity (but that typically annually update IRC references) will not conform until they pass legislation to adopt the new IRC (and they may modify their conformity when they do so).
- Static conformity or code-specific conformity states will not conform until they pass legislation.
- Section 163(o) provides a 5-year carryforward. A state decoupling from federal treatment (whether it be from Section 163(j), Section 163(n), or a combination thereof) will have to track state-specific carryover modifications.

Dividends received deduction increase

- Depends on whether a state DRD is dependent on or independent of Section 243

Major state corporate tax impact of federal tax reform (House Ways & Means markup)

Modifications to GILTI and FDII

- State impact of GILTI calculation changes depends on varying state conformity to Section 951A and DRD treatment
- FDII and GILTI deductions depend on conformity to Section 250 and its subsections
 - There may be uncertainty on how states that have addressed specific IRC provisions will respond to those provisions being modified or recodified (e.g., removing Section 250(a)(2) and recodifying Sections 250(a)(1)(A) and (B) to Sections 250(a)(1) and (2))

Modifications to Section 245A

- Same as federal to the extent that states conform to Section 245A
- States that do not conform to Section 245A may have foreign DRDs that may apply

Impact of SHIELD

- States generally have not conformed to BEAT.
- Adoption of SHIELD could have state implications

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CONSIDERATIONS AND PLANNING



Merger and acquisitions accelerate

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Merger and acquisition activity accelerates

- Most M&A activity in both the United States and globally since at least 1995 and active M&A trend set to continue into 2022
- Middle-market companies, private-equity firms and SPACs dealing with M&A considerations

Considerations

- Critical importance of both buyer and seller pre-sale tax diligence, evaluation of transaction structure and accounting for and addressing post-sale tax contingencies
- Changes in federal and state and local tax laws and regulations, judicial developments, and administrative guidance can present tax traps and pitfalls for the unwary and may significantly increase SALT exposure without involvement of experienced M&A state tax advisors

Tax reform

- Is activity driven by the Biden administration's proposals (i.e., getting in before the hammer) or is the current landscape the sweet spot?

Remaining flexible is key

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Federal changes can impact compliance just as TCJA and CARES

- Potential for structural international changes
- Increase to individual and corporate rates
- SALT deduction limitation changes

State economic outlooks change quickly

- What will states target in 2022/FY23?
 - If collections and budgets remain solid than perhaps very little from a tax perspective
 - If federal tax reform occurs then expect delayed guidance and slow state responses
- Expanded taxation of digital goods and services, and advertising will remain popular
- P.L. 86-272 guidance could impact anyone taking or considering a position
- Sales tax revenues appear to be back on track, but services remain mostly untaxed

Contact information

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