COST
Council On State Taxation

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State Tax Research Institute

The Impact of Federal Tax Reform on State Corporate Income Taxes

Including the Council On State Taxation's state conformity principles and the EY report examining the impact of federal tax reform on state corporate income taxes

ABOUT COST

The Council On State Taxation (COST) is a nonprofit trade association consisting of nearly 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

ABOUT STRI

The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST). For more information on STRI, please contact Douglas L. Lindholm at dlindholm@cost.org.

Message from STRI's President:

The Council On State Taxation (COST) and our research affiliate, The State Tax Research Institute (STRI), have long been committed to increasing the body of knowledge and enhancing public dialogue relating to the state and local taxation of business entities. We are pleased to present our latest contribution to that effort, "The Impact of Federal Tax Reform on State Corporate Income Taxes," by Andrew Phillips and Steve Wlodychak of the National Tax Practice of Ernst & Young LLP (EY).

Congressional enactment of the 2017 Tax Cuts and Jobs Act (TCJA) heralded the most significant changes to our federal tax system in over thirty years, affecting both individual and corporate income taxes. The corporate tax changes to a large degree reflected a realization that our federal corporate income tax system was in need of fundamental reform. Our combined federal and state corporate income tax rate – formerly the highest in the industrialized world – reduced our nation's economic competitiveness. Further, our worldwide system of taxation created significant disincentives for companies to remain headquartered in the United States. The corporate changes in the TCJA addressed these competitive disadvantages by reducing the corporate income tax rate, providing incentives for domestic investment, and adopting a quasi-territorial system of taxation.

One unintended consequence of federal tax reform is a significant increase in state corporate income taxes. This arises because states typically conform to federal provisions that impact the tax base, but not the federal corporate tax cuts. The EY study assesses the impact that the corporate tax provisions of the TCJA will have on respective states' corporate income taxes. Its overall conclusion is that conformity with federal tax reform will result in an estimated state corporate tax base increase averaging 12% for the first ten years, with a range generally between 7% and 14% in individual states.

COST has included as a preface to the EY Study a set of **Principles** to guide states in their conformity with federal corporate income tax reform. These principles encourage states to avoid using federal tax reform conformity as a vehicle for increasing the overall state business tax burden, disadvantaging certain business sectors or entity types, or harming the state's economic competitiveness.

Douglas L. Lindholm

President & Executive Director

State Tax Research Institute

COST's Principles of State Business Tax Conformity with Federal Tax Reform

Federal tax reform presents state policymakers with significant policy choices regarding individual and business taxation. It is anticipated that conformity with federal base-broadening provisions will result in a significant revenue windfall for most states, particularly with regard to corporate taxation. It is important that states avoid using federal tax reform conformity as a vehicle for increasing the overall business tax burden, disadvantaging certain business sectors or entity types, or harming the state's economic competitiveness. Rather, states should seek to leverage any revenue gains from federal tax reform borne by the business community to remedy existing inequities in taxing businesses and to help improve the business climate. To further these goals, COST endorses the following principles of state business tax conformity with federal tax reform:

Manage Conformity to Achieve Revenue Neutrality and Avoid Increasing the State's Business Tax Burden

At the federal level, the Joint Committee on Taxation has estimated that the Tax Cuts and Jobs Act (federal tax reform) will result in corporate income tax reductions over the first 10 years of $329.4 billion.[i] This amounts to a reduction of about 10% year in corporate income taxes at the federal level. Conversely, at the state level, federal tax reform will result in revenue increases given that states generally do not conform to federal provisions that lower revenue (*e.g.*, tax rate cuts), but will conform to many of the federal provisions that increase revenue (*e.g.*, base-broadening measures). Based on the attached Ernst & Young study, Impact of Federal Corporate Tax Reform on State Corporate Tax Bases, conformity with federal tax reform will result in an estimated state corporate tax base increase of about 12% for the first ten years.[ii] According to the EY study, the base increase in individual states will range 7% to 14%.

States should carefully analyze potential state corporate income tax increases and consider other state level tax reforms that would achieve revenue neutrality. Further, such conformity and state-level reforms, taken together, should not increase business taxes, which nationwide are a stable and significant contributor to state and local finances (nearly 45 percent of state and local taxes are historically borne by businesses).[iii] States also should not shift tax burdens onto businesses at the state level to alleviate perceived problems at the federal level (for example, a state should not adopt a payroll tax in reaction to the federal cap on state individual income tax deductions).

Do Not Selectively Conform to Revenue-Increasing Federal Law Changes Only

States should avoid imbalanced conformity to federal tax reform arising from adopting revenue-increasing changes while decoupling from revenue-decreasing provisions. This is especially true when changes are adopted in tandem at the federal level to effectuate certain policy goals. For instance, the new federal tax on the global intangible low-taxed income (GILTI) earned by foreign affiliates, if adopted by a state, should be paired with the adoption of the companion federal provision (e.g., the new I.R.C. Section 250). Section 250 has two revenue offsetting provisions intended at the federal level to balance the impact of the GILTI provision. First, Section 250 provides a 50% deduction (later lowered to 37.5%) that reflects the federal policy of taxing GILTI foreign source income at only one-half the rate of other federal taxable income. Second, I.R.C. Section 250 also includes an incentive for domestic production achieved by means of a reduced rate tax on companies with foreign-derived intangible income (FDII) derived from a trade or business within the U.S. Nonetheless, almost one-half of the states currently conform to "line 28" federal taxable income before special deductions, and thus may not clearly link to the new Section 250.[iv] To avoid this uneven and unfair treatment, some states will need to add Section 250 conformity to their corporate income tax statutes.

Similarly, it is generally thought that the allowance of 100 percent expensing of business investments (revenue decrease) was intended to be paired with the limitation on net interest deductions (revenue increase). These two provisions were coupled in the federal legislation with the dual intent to incentivize business investment and expansion while discouraging the use of more debt for such purposes.[v] However, while it is expected that virtually all of the states (absent amendments to the contrary) will conform to the interest limitation provisions, approximately two-thirds of the states currently opt out of bonus depreciation and are likely to not conform to the 100 percent expensing provision (again, absent action to conform).[vi] This is an especially unfair outcome as the interest rate limitation will generally increase the state corporate income tax base by about 6.4%, while the 100% expensing would only decrease the corporate tax base by about 1.8%.[vii]

It is particularly important to avoid conforming to only the revenue-raising provisions of federal tax reform, where possible, because so many base broadeners, such as the repeal of the domestic production activities deduction and the amortization of certain research and experimentation expenditures, are intended to offset corporate tax rate cuts to which none of the states conform.

Do Not Conform to New Foreign Source Income Provisions that Would Expand the State Tax Base beyond the Water's Edge

Federal tax reform includes a number of provisions that impact the taxation of foreign source income. The final legislation imposes a one-time transition tax under a special subpart F classification on accumulated foreign earnings held overseas. The legislation also imposes a tax on certain earnings of a U.S. corporation's foreign affiliates, referred to as global intangible low-taxed income (GILTI), which is determined by aggregating all foreign affiliates' earnings from active foreign business operations. The legislation implements a base erosion anti-avoidance tax (BEAT) provision, which imposes a tax generally on the amount of deductions large U.S. corporations take for payments they make to related foreign affiliates. The legislation provides for a reduced rate of tax on certain income that U.S. companies earn from servicing foreign markets, known as foreign-derived intangible income (FDII). Finally, there is a new requirement for the amortization of research and experimental expenditures that favors domestic production over foreign production.

First, with regard to the new transition tax on accumulated foreign earnings, only a modest number of states will tax a portion of these "deemed dividends" because these states only partially conform to the federal taxation of subpart F income and/or foreign dividends.[viii] Other states should avoid expanding their tax base retroactively (for tax year 2017) to include this special classification of subpart F income in their tax base. Such income inclusion at the state level would not reflect business activity related to the generation of income in any U.S. state. To the extent a state picks up the one-time federal "repatriation" in its tax base under this transition tax, it should allow the offsetting deductions in I.R.C. Section 965(c) (that effectively lower the tax rate); the eight-year payment schedule permitted under federal tax reform; and factor relief in apportioning such income to the state.

Second, with regard to foreign source income provisions such as GILTI and BEAT, states should refrain from expanding their combined or separate entity filing regimes to include foreign source income not currently in the state tax base. States have traditionally not followed the approach taken by the federal government in taxing foreign source income on a deferred or current basis. Over the last 30 years, states have generally limited their corporate income tax base to the waters' edge – that is, to income earned in the U.S. With federal tax reform, the federal government is expanding its **current** taxation of foreign source income primarily to achieve two objectives that either do not apply to the states or cannot legally apply to the states. First, Congress is raising $324 billion over 10 years from international tax reform to help pay for $654 billion over 10 years in other business tax reform cuts.[ix] The states, by contrast, do not conform to the federal corporate tax cuts and therefore have no reason to expand their tax base to make up for the lost revenue. Second, the new taxation of foreign source income and related provisions is intended to shift the U.S. tax laws toward favoring domestic commerce over foreign commerce. While this may be a

permissible goal for the federal government, states are limited by constitutional provisions such as the Foreign Commerce Clause that make it impermissible to favor domestic commerce over foreign commerce.[x]

To the extent that a state decides to expand its tax base to include GILTI or other new foreign source income provisions, it should also enact complementary deductions (see the I.R.C. Section 250 discussion above); follow the 100 percent federal dividends received deduction (respecting the federal territorial regime); and repeal other overlapping foreign source income-related measures. These include expense "addback" statutes that apply to payments made to foreign related entities, state "tax haven" designations, and discretionary adjustments to water's-edge filings. Further, such states must allow factor representation for foreign source income (*e.g.*, include the foreign receipts that generated the GILTI income in the denominator of the sales factor) to fairly assign the income to the appropriate jurisdiction. Inclusion of GILTI or the deemed repatriation without the associated apportionment factors of foreign entities generating the income is impermissible under the Commerce Clause of the U.S. Constitution.

Beware of Unintended Consequences and Policy Deviations between Federal and State Outcomes

COST's State Tax Research Institute recently released a study prepared by PricewaterhouseCoopers LLP entitled "Corporate and Pass-Through Business State Income Tax Burdens: Comparing State-Level Income and Effective Tax Rates."[xi] This pre-federal tax reform study concluded that the overall state-level effective tax rate for business income earned by C corporations is 30 percent higher than the aggregate state effective tax rate for business income earned by pass-through entities. States should take steps to mitigate rather than exacerbate disparate tax treatment resulting from choice of entity.

The federal tax reform legislation provides favorable treatment for pass-through income by including a 20 percent deduction (applied against taxable income) for the non-wage portion of pass-through income. The minority of states that conform to federal taxable income as their starting point for determining the state personal income tax base would through conformity inadvertently pick up this deduction but not the corresponding corporate tax rate reductions in the federal legislation.[xii] This outcome would be inconsistent with the intent of the federal legislation to minimize choice-of-entity concerns by providing similar rate relief to both C corporations and pass-through entities.

Prepare for Additional Complexities in State Income Tax Compliance Caused by Conformity with Federal Tax Reform Provisions

It is expected that federal tax compliance will increase in complexity given the enormity of the substantive and administrative changes included within federal tax reform. This complexity will carry over to the states both in terms of provisions the states conform to and additional differences that arise from non-conformity.

For example, as noted above, if states conform to the new foreign source income provisions, they may end up taxing foreign source income that was not previously included in the state income tax base. If this occurs, states will need to address issues that are not present at the federal level, such as redundancy with current state related party "addback" provisions, tax haven rules, apportionment and factor relief, nexus, and potential constitutional issues. Another example involves those states that fail to conform to the new federal expensing provisions. As with decoupling from "bonus" depreciation in the past, such states should provide deductions that cumulatively allow full depreciation in subsequent years, as well as providing requisite state basis adjustments. States adopting the federal interest expense limitation will need to apply that limitation (computed on a consolidated group basis) to state consolidated, combined, and separate entity filings, harmonize the limitation with existing interest-expense addback rules, and otherwise find ways to minimize the burdens of taxpayer compliance.

States must provide timely administrative guidance to taxpayers, as circumstances arise, to provide clarity on the state tax implications of many new substantive changes to the tax code. States failing to provide

necessary guidance by estimated payment due dates should abate resulting underpayment penalties as well as waive interest, where permitted by law.

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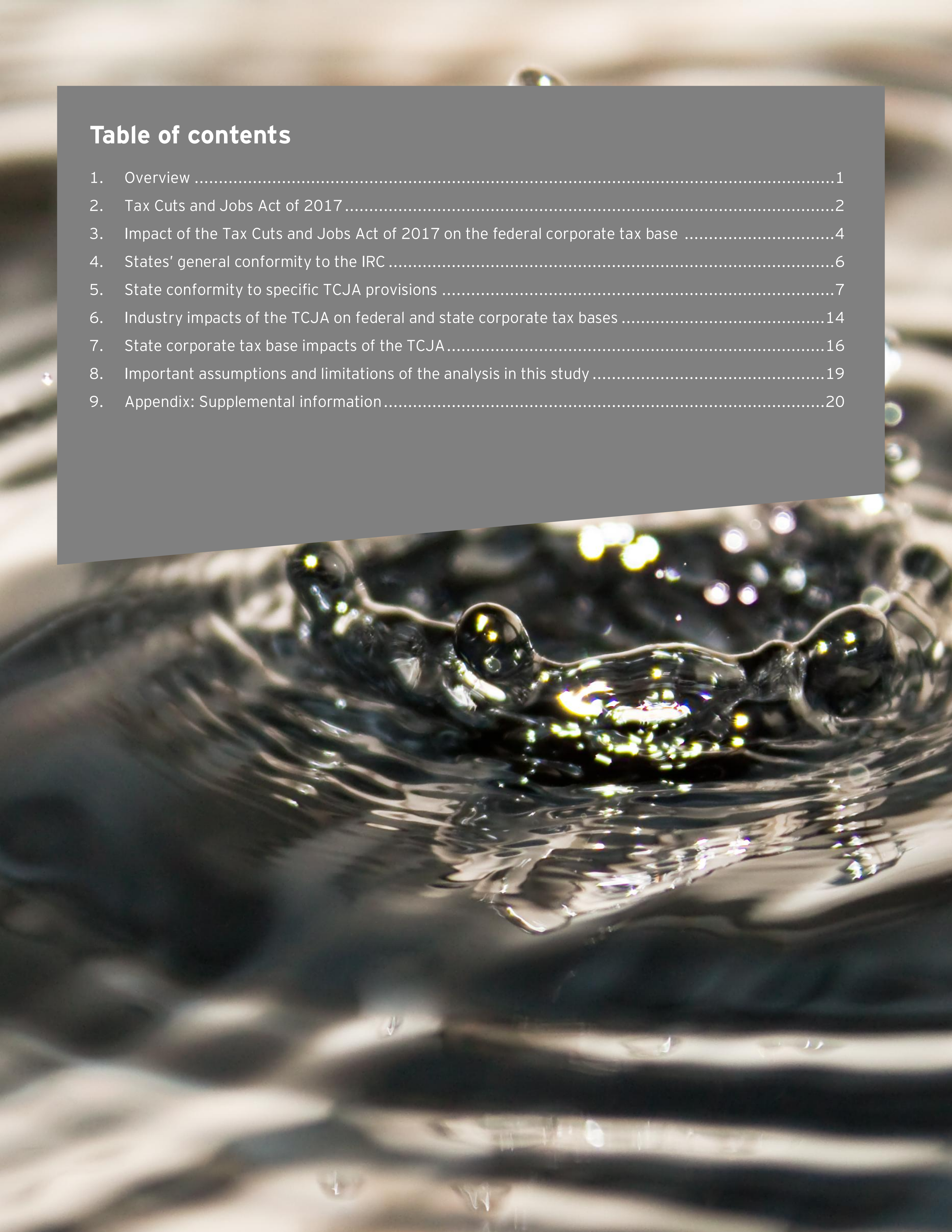
[i] See Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act," the Joint Committee on Taxation, JCX-67-17, Dec. 18, 2017, available at: https://www.jct.gov/publications.html?func=startdown&id=5053.
[ii] See The Impact of Federal Tax Reform on State Corporate Income Taxes, Table 5.
[iii] See Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2016, EY, COST, and STRI, August 2017, available at: http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/fy16-state-and-local-business-tax-burden-study.pdf.
[iv] See The Impact of Federal Tax Reform on State Corporate Income Taxes, Figure 6.
[v] As evidence of this coupling, the federal tax reform excluded from the definition of qualified property for immediate expensing certain property used in a real property trade or business or certain property used in the trade or business of certain regulated public utilities, which in turn were excluded from the interest deduction limitation.
[vi] See The Impact of Federal Tax Reform on State Corporate Income Taxes, Figure 3.
[vii] *Id.*, Tables 2 and 6.
[viii] *Id.*, Figure 7.
[ix] See Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act," the Joint Committee on Taxation, JCX-67-17, Dec. 18, 2017, available at: https://www.jct.gov/publications.html?func=startdown&id=5053.
[x] See *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992).
[xi] Prepared by PricewaterhouseCoopers LLP, October 2017, available at: http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/etr-study---pwc-stri-combined.pdf.
[xii] See *Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform*, Tax Foundation, Special Report No. 242, Jan. 2018, Table 6, available at: https://taxfoundation.org/state-conformity-federal-tax-reform/. These states are: Colorado, Minnesota, North Dakota, Oregon (with adjustments), South Carolina, and Vermont.

The impact of federal tax reform on state corporate income taxes

Andrew Phillips and Steve Wlodychak

Prepared for the State Tax Research Institute (STRI)

March 2018



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Executive summary

The Tax Cuts and Jobs Act of 2017 (P.L. 115-97)[1] (TCJA) contains the most significant changes to the Internal Revenue Code in 30 years. At the federal level, the TCJA includes various corporate tax provisions which, on net, broaden the tax base while reducing the rate and providing an overall reduction in federal corporate income tax. While the effect of the TCJA on the federal taxation of corporations has been much discussed, less well understood are the impacts these changes will have on state corporate income tax bases and, in particular, the potential increase in state corporate tax burdens.

At the state level, conformity with the federal corporate tax base expansion will likely result in increased corporate tax collections, but the magnitude of that impact for each state will depend on how it chooses to conform to the new Internal Revenue Code (IRC), the composition of its economy, and the way in which specific provisions contained within the TCJA are implemented at the federal level.

All states levying a corporate income tax reference the IRC in some fashion. Most start with taxable income from the federal Form 1120, then apply specific adjustments which vary by state. A small number of states take different approaches starting with federal gross receipts, while several states do not levy a tax based on net income. Even in states with a federal taxable income starting point for the state tax base computation, varying conformity to federal provisions will cause differences in the magnitude of impact of federal tax reform across states. In some "rolling conformity" states which conform directly to the IRC as it is amended, the changes in the TCJA are already part of that state's tax law. In others, known as "fixed" or "static" conformity states, the TCJA changes will generally be incorporated when the state's legislature enacts legislation to conform.

This study provides estimates of the potential impact on state corporate tax bases over the next decade if all states (rolling and fixed conformity) update their conformity dates to link to the TCJA, but remain coupled to specific provisions as they have in the past. This analysis is necessarily an approximation. There will be varying interpretations of how each state's tax code ties to some of the novel provisions included within the TCJA. Some states may make changes to the state tax code in conjunction with federal tax reform to achieve goals other than conformity with the new federal tax rules. Other states may conform to the federal tax provisions differently than they have in the past. Finally, there are likely to be constitutional challenges that limit the ability of states to impose tax on certain types of income now included in the federal tax base – particularly in relation to the taxation of foreign source income. This analysis is not intended to provide a guide to what states will actually do in relation to federal tax reform, or what they should do to maintain competitiveness or generate tax revenue. Rather, the analysis is intended to provide a baseline reflecting the potential magnitude of the state corporate tax base expansions that could occur with state conformity to the provisions of the TCJA.

Table ES-1 provides estimates of the potential expansion in the state corporate income tax bases by state from the major provisions contained in the TCJA. The estimated nationwide overall increase in state corporate income tax bases is 12% over the 10-year period, with significant variations between the states. The impacts on state corporate tax bases will fluctuate over the 10-year period. The average expansion in the state corporate tax base is estimated to be 8% from 2018 through 2022, which increases to 13.5% for the period 2022 through 2027. This increase in the later years is primarily attributable to research and experimentation (R&E) expense amortization beginning in 2022 and the change in the calculation of the interest limitation in the same year.

It is worth noting that even if a state decides not to conform to any of the new provisions imposing a tax on foreign source income, the increase in the state corporate tax base is likely to average 10%.

One key assumption made in the study should be highlighted because of its impact on the estimated expansion of the corporate tax base. The analysis assumes all states will conform to new deductions provided under IRC Section 250 related to foreign-derived intangible income (FDII) and global low-taxed intangible income (GILTI), to the extent such income is included in the state tax base. However, there is still great uncertainty over whether states, particularly those currently linking to Line 28 of the federal tax return, will conform to the new IRC Section 250 deductions. To the extent states do not conform to these deductions, the overall state corporate tax base expansion would be greater by an estimated 4%. Similarly, if states for interpretative, legal, political, or economic reasons conform (or not) to other

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[1] A copy of the Tax Cuts and Jobs Act (P.L. 115-97) can be found on the US Congress' website at https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf (last accessed Feb. 4, 2018).

provisions of the TCJA (differently than as assumed in this study), the increase or decrease of the state corporate tax base from that stated in Table ES-1 can be approximated by referring to the estimate of the federal impact in Table 2.

Federal tax reform has the potential to significantly expand state corporate tax bases. Now that the TCJA is federal law, every state legislature will need to address the state changes triggered by adoption of the TCJA. The 2018 legislatures in a number of states are already dealing with the issue of conformity to the TCJA corporate tax base changes.

Table ES-1. Estimated percentage change in state corporate tax base from Tax Cuts and Jobs Act, by state (2018-2027, consistent with federal fiscal year)

State	% increase in state corporate tax base	State	% increase in state corporate tax base
Alabama	11%	Nebraska	11%
Alaska*	12%	Nevada	n/a
Arizona	14%	New Hampshire*	13%
Arkansas	12%	New Jersey*	12%
California**	12%	New Mexico*	11%
Colorado	12%	New York*	12%
Connecticut*	12%	North Carolina	12%
Delaware	10%	North Dakota	10%
Florida	13%	Ohio	n/a
Georgia	12%	Oklahoma	13%
Hawaii*	13%	Oregon*	10%
Idaho	9%	Pennsylvania*	14%
Illinois	9%	Rhode Island*	11%
Indiana*	12%	South Carolina	12%
Iowa	13%	South Dakota	n/a
Kansas	11%	Tennessee*	12%
Kentucky*	12%	Texas	n/a
Louisiana	12%	Utah*	12%
Maine	12%	Vermont	14%
Maryland*	12%	Virginia	13%
Massachusetts*	12%	Washington	n/a
Michigan	9%	West Virginia	9%
Minnesota*	12%	Wisconsin*	9%
Mississippi*	4%	Wyoming	n/a
Missouri	11%	District of Columbia	12%
Montana*	9%	Overall change	12%

Source: Ernst & Young LLP analysis

Note: states indicated as "n/a" do not impose a corporate net income tax. The overall change is calculated as the weighted average change across all states levying a corporate net income tax; in this calculation, states are weighted by their corporate net income tax base, which is calculated by dividing state corporate tax collections as reported by the US Census Bureau for FY2016 by the statutory corporate tax rate in each state.

* State starts with Form 1120 line 28. To the extent IRC Section 250 deductions are not allowed, this impact would be higher by 4%.

** There may be a California impact relating to cash repatriation for waters-edge filers once the deemed repatriated earnings have been actually distributed as dividends to U.S. corporate shareholders. California has estimated this amount at approximately $350 million. See https://www.ftb.ca.gov/aboutFTB/newsroom/Preliminary-Review-of-Federal-Tax-Reform-Part-1.pdf

1. Overview

The Tax Cuts and Jobs Act of 2017 (P.L. 115-97)[2] (TCJA) signed into law by President Trump on December 22, 2017, contains the most significant changes to the Internal Revenue Code of 1986, as amended (IRC)[3] in 30 years. At the federal level, the TCJA includes various provisions, which, on net, broaden the tax base while reducing the rate and providing an overall reduction in federal corporate income tax.

While the effect of the TCJA on the federal taxation of businesses has been much discussed, less well understood may be the impacts these changes will have on state corporate income tax revenues. This is because in some way, shape, or form every state which imposes a corporate income tax ties directly or indirectly to the provisions of the IRC, although not to the federal tax rates. In some states which conform directly to the IRC as it is amended, (known as "rolling" conformity states) the changes in the TCJA are already part of that state's tax law. In others, known as "fixed" or "static" conformity states, the TCJA changes will generally be incorporated when the state's legislature enacts legislation to conform. The degree of tax base expansion in each state will depend on how a state conforms or chooses not to conform to the new IRC, the composition of its economy, and the way in which specific provisions contained within the TCJA are implemented at the federal level. This analysis provides estimates of the impacts of major TCJA provisions on state corporate tax bases, based on the currently available information and in the absence of certain authoritative guidance, the analysis makes assumptions about how states will respond in terms of incorporating federal corporate income tax base changes through updates to the IRC.

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[2] A copy of the Tax Cuts and Jobs Act (P.L. 115-97) can be found on the US Congress' website at https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf (last accessed Feb. 4, 2018).

[3] References to "Section" or "§" are to the Internal Revenue Code of 1986, as amended (IRC) including the amendments made to any such Section by the TCJA (unless stated otherwise).

2. Tax Cuts and Jobs Act of 2017

The TCJA marks the first major overhaul of the federal income tax in more than 30 years. It permanently reduces the federal corporate tax rate from a maximum of 35% to 21% effective January 1, 2018 and eliminates the corporate alternative minimum tax. It moves the US taxation of multinational businesses from a worldwide to a quasi-territorial regime, more consistent with most of its major international trading partners. It sets deemed repatriation tax rates for the transition to a territorial tax system on US shareholders of foreign subsidiaries at 15.5% for previously untaxed earnings held in cash or other specified assets, and 8% for the remainder. Going forward, dividends received from foreign corporations by 10% (or more) US shareholders will be 100% deductible. A host of new international tax provisions intended to make the US tax competitive in global markets are included. The TJCA retains the anti-deferral regime (i.e., Subpart F) and adds a new regime which subjects to US tax global intangible low taxed income (GILTI). New interest expense limitations are imposed but at the same time, bonus depreciation would be increased from 50% to 100% for "qualified property" placed in service after September 27, 2017 and before 2023 and in a significant change from prior law, the original use of the property need not commence with the taxpayer. Expensing was increased to $1 million for qualified property placed in service in tax years beginning after 2017. The deduction for interest expense is limited to 30% of "adjusted taxable income" (ATI) plus business interest income, with special elections available for real property trades and businesses. For the first four years after enactment of the TCJA, ATI would be computed without subtracting depreciation, amortization, or depletion in addition to interest and taxes (EBITDA). Thereafter (beginning in 2022), ATI would be decreased by depreciation, amortization, or depletion, thus making the computation 30% of net interest expense exceeding earnings before interest and taxes (EBIT).

For most corporate net operating losses (NOL) arising in tax years beginning after 2017, the NOL deduction is limited to 80% of taxable income and the carryback provisions are repealed. For most corporations, an indefinite carryforward is allowed.

Table 1. Overview of major TCJA provisions affecting corporate tax base

Provision	Description
Net interest expense limitation	▸ Limits deduction to net interest expense that exceeds 30% of adjusted taxable income (ATI) plus business interest income.[4] ▸ Initially, ATI computed without regard to depreciation, amortization or depletion. Beginning in 2022, ATI would be decreased by those items.
Expensing (provided under Section 168(k) bonus depreciation)	▸ Immediate deduction of qualified property placed in service after September 27, 2017 and before 2023. ▸ Increased expensing phases-down starting in 2023 by 20 percentage points for each of the five following years. ▸ Eliminates original use requirement. ▸ Taxpayers may elect to apply 50% expensing for the first tax year ending after September 27, 2017.
Like kind exchange changes	▸ Limits to exchanges involving real property only. Current law applies to exchanges if property disposed of on or before December 31, 2017 or the property received in the exchange is received on or before such date.
Net operating losses (NOL)	▸ Limits NOLs to 80% of taxable income for losses arising in tax years starting after 2017. ▸ Generally repeals carryback provisions ▸ Allows NOLs to be carried forward indefinitely, subject to interest rate adjustment.
Domestic dividends received deduction (DRD)	▸ Retains the 100% dividends received deduction for members of the same consolidated group, reduces the deduction for dividends received from a 20% owned corporation from

[4] Special elections are available for real property trades and businesses as well as certain types of regulated utilities.

Provision	Description
	80% to 65%, and reduces the deduction for less than 20 percent owned corporations from 70% to 50%.
Foreign dividends received deduction (DRD)	▸ Domestic corporations allowed a 100% deduction for the foreign-source portion of dividends received from 10% owned (vote or value) foreign subsidiaries. ▸ Deduction is not available for capital gains or directly-earned foreign income.
Amortization of research and experimentation expenditures	▸ Requires amortization of domestic research and experimentation (R&E) expenditures over five years. ▸ 15 year amortization for R&E conducted outside the US. ▸ R&E specifically includes expenses for software development. ▸ Requires amortization for expenses incurred in tax years beginning after 2021.
Domestic production deduction (Section 199)	▸ Repeals the deduction for tax years beginning after 2017.
Transition tax	▸ One-time transition tax on post-1986 earnings of 10% owned foreign subsidiaries accumulated in periods of 10% US corporate shareholder ownership. ▸ 15.5% rate on cash and cash equivalents, and 8% rate on the remainder.
Global Intangible Low Taxed Income (GILTI)	▸ This provision is meant to discourage the location of high-value activities outside the US. ▸ It functions as a mandatory annual inclusion of global intangible low taxed income (GILTI) determined on an aggregate basis for all controlled foreign corporations owned by the same US shareholder, with partial credits for foreign taxes properly attributable to the GILTI amount. ▸ The GILTI inclusion effectively taxes foreign earnings in excess of a 10% rate of return on fixed assets at a reduced rate by providing a 50% deduction initially (subject to certain limitations), reduced to 37.5% for tax years beginning after 2025. At a 21% federal corporate tax rate, the deduction results in effective rates of 10.5% and 13.125% respectively).
Foreign Derived Intangible Income (FDII)	▸ This provision is generally designed to encourage locating intangible assets in the US by providing a lower effective tax rate on high-returns related to foreign sales. While this calculation is more complex than GILTI, the calculation is similar in that returns in excess of 10% of fixed assets form the basis of the calculation. ▸ This is achieved by providing domestic corporations a deduction against foreign-derived intangible income (subject to certain limitations) of 37.5% initially, reduced to 21.875% for tax years beginning after 2025. At a 21% federal corporate tax rate, the deduction results in effective rates of 13.125% and 16.40625% respectively.
Base Erosion Anti-Abuse Tax (BEAT)	▸ The BEAT functions as a minimum tax which will be paid by taxpayers with significant payments to foreign related entities. ▸ If certain thresholds are met (e.g., a global corporate group which has a three-year annual average of at least $500 million of gross receipts), BEAT is levied on an applicable taxpayer's taxable income determined without regard to certain deductible amounts paid or accrued to foreign related persons; depreciation or amortization on property purchased from foreign related persons; and certain reinsurance payments to foreign related persons. ▸ Generally 10% rate for tax years beginning before 2026, and 12.5% thereafter (but 11% and 13.5% for banks and registered securities dealers).

Source: Ernst & Young LLP

3. Impact of the tax cuts and jobs Act of 2017 on the federal corporate tax base

The TCJA will impact state corporate income tax bases through significant changes in the determination of federal corporate taxable income, which are adopted by the states. Therefore, the first step in estimating the impact on state tax bases is to estimate the change in the federal corporate tax base resulting from each TCJA provision.

The starting point used in this analysis is the 10-year estimate of federal budgetary impacts of the TCJA produced by the Joint Committee on Taxation (JCT).[5] Since the key impact for state corporate tax systems is the change in the corporate tax base, the estimated 10-year revenue impact for each major federal provision was translated into an estimated change in the federal tax base by grossing up by the applicable federal rate. The 21% rate was used to convert the impact on federal tax revenues into an estimate of the relevant change in the amount of corporate taxable income. Since the BEAT is a minimum tax which does not impact the federal income tax base and therefore should not affect the state income tax base, it is not included in the table.[6] Additionally, GILTI was split into an inclusion and a separate deduction amount based on the statutory deduction percentage in each year. Table 2 presents the overall estimated change in the federal corporate tax base from the major provisions included in this analysis.

As shown in Table 2, the federal tax base expansions due to interest limitation, research and expenditure amortization, limitation of like kind exchange for personal property, and fringe benefit limitations total approximately 10%. Since virtually all of the states conform to these provisions (see Table 6), these changes represent a large portion of the overall expansion of the tax base in most states. As a result, the variation in the magnitude of the impact among states is largely due to their conformity (or lack thereof) with the international tax provisions.

The next section explains how the federal aggregate estimates are transformed into estimates of the potential size of state corporate income tax base changes.

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[5] See The Joint Committee on Taxation, JCX-67-17, Estimated Budget Effects of The Conference Agreement for H.R.1, The "Tax Cuts and Jobs Act" (available on the Internet at https://www.jct.gov/publications.html?func=startdown&id=5053 (last accessed Feb. 4, 2018).

[6] While several states (e.g., Minnesota) did adopt the concept of a corporate alternative minimum tax, they were based on state-specific provisions, not the federal AMT provisions.

Table 2. Estimated change in the US federal corporate tax base due to the Tax Cuts and Jobs Act of 2017, by major provision (average percentage change in US economy-wide corporate tax base, 2018-2027; the percentage changes in each year will vary)

Business provision	% change in federal corporate tax base
One-time transition tax on un-repatriated foreign earnings	+9.0%
Net interest expense limitation (30% of ATI)	+6.4%
Modification of net operating loss deduction	+5.3%
Global intangible low-taxed income (GILTI) inclusion	+5.5%
Deduction for global intangible low-taxed income (GILTI)	(2.6%)
Amortization of research and experimental expenditures	+2.9%
Repeal of domestic production activities deduction	+1.9%
Limit deduction of fringe benefits	+0.7%
Limit like-kind exchanges of personal property	+0.5%
Base erosion anti-abuse tax (BEAT)*	0.0%
Increased expensing under Section 179	(0.3%)
Small business accounting method reform and simplification	(0.8%)
Foreign derived intangible income (FDII) deduction	(1.7%)
Expensing provided under Section 168(k) bonus depreciation	(1.8%)
Move to territorial system of taxation	(5.9%)
Total change in federal corporate taxable income from major provisions**	+19.1%

Source: Ernst & Young LLP analysis incorporating JCT revenue estimates

* BEAT is a minimum tax and does not impact the regular tax base

** Total reflects only major provisions shown in this table

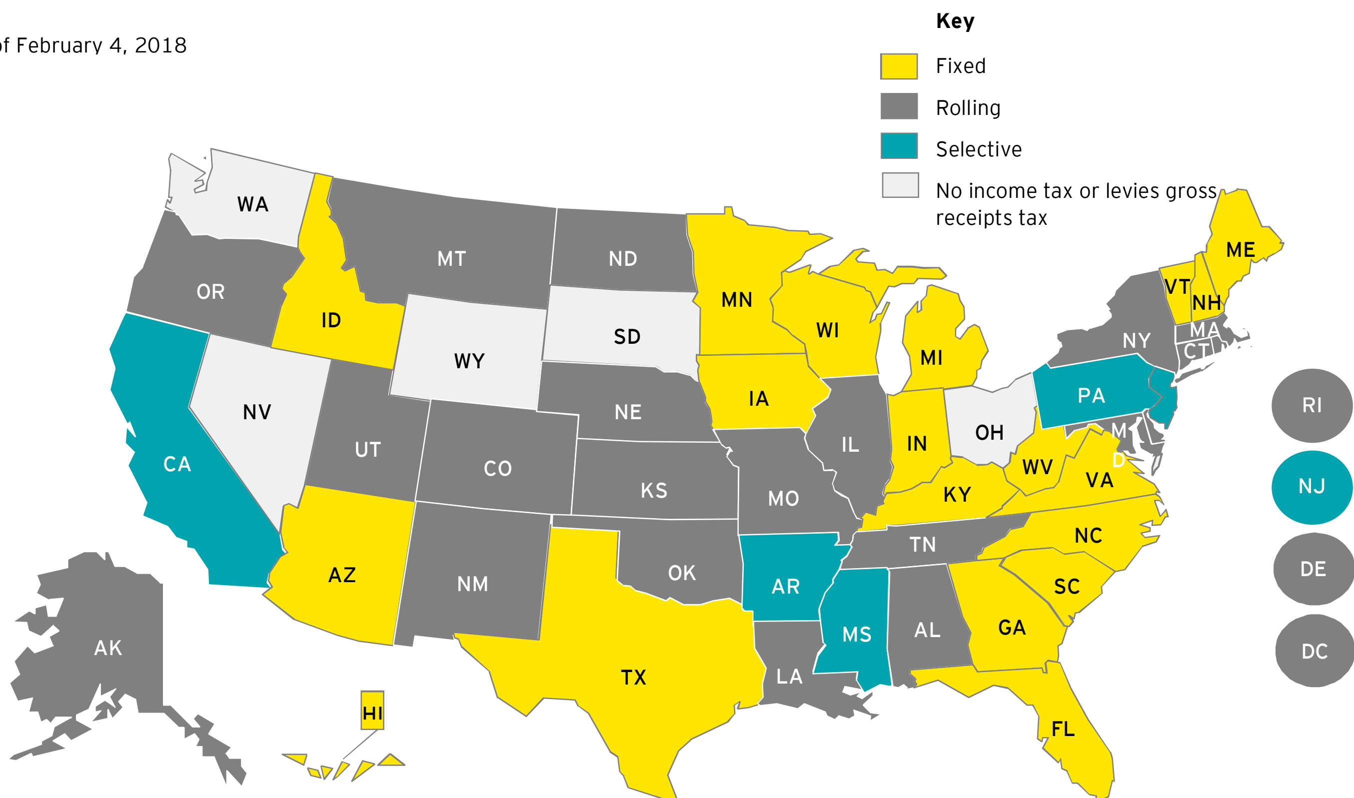
Note: table does not sum due to rounding

4. States' general conformity to the IRC

Much of the difference in the impact of TCJA and its reforms of the federal income tax base on state corporate income tax bases will result from the variation in states' conformity to the IRC. This depends upon which federal corporate tax base changes states adopt. This analysis assumes that states will adopt the federal changes that are consistent with the federal corporate income concept that is used as the starting point for the calculation of state corporate tax liability prior to enactment of the TCJA.

As shown in Figure 1, state conformity approaches generally fall into one of four categories: (1) rolling conformity, in which states conform to the IRC as currently in effect; (2) fixed date conformity, in which states conform to specific sections of the IRC as in effect on a certain date (commonly referred to as "fixed" or "static" conformity states); (3) selective conformity, in which states conform to specific IRC sections as of specific dates, which may be different dates depending on the IRC section or may pick and choose specific provisions of the IRC to which they conform, or (4) no conformity because the state does not levy an income tax.[7] Additionally, across states with all three types of IRC conformity, it is common for states to decouple from certain Sections of the IRC, such that certain deductions or types of income are not considered when calculating taxable income subject to state apportionment for a multistate business (i.e., the state may choose not to include by reference the particular item of income or deduction specified in a Section of the IRC either by outright exclusion of the income or by a subtraction modification (or addback) of the deduction in determining the state tax base).

Figure 1. State corporate conformity regimes[8]



[7] While the Texas corporate franchise tax has a fixed date conformity to the IRC for purposes of calculating its Franchise Tax, it only relies on the IRC to determine a taxpayer's total income before deductions. It does not generally follow the IRC deductions to determine its corporate franchise tax base.

[8] Even within the four broad categories, there are wide variations in approaches by the states. In California, for example, while it is generally a fixed date conformity state, for some provisions, most notably the IRC's treatment of Subpart F income, it is a rolling conformity state (even though it does not subscribe to the acceleration of recognition of Subpart F income for income received from foreign subsidiaries). As another example, Michigan is listed as a rolling conformity state but corporate taxpayers can annually elect to have the current year IRC provisions apply in determining their state corporate tax liability.

5. State conformity to specific TCJA provisions

Each state's conformity with specific sections of the IRC determines the extent to which it is impacted by the TCJA. A critical assumption in this analysis, which does not necessarily reflect what the states will ***actually do***, is that ***all states*** will update their conformity dates to the IRC as of January 1, 2018 but will otherwise continue to conform or decouple, as the case may be, to specific IRC Sections as they do under current law. That is, all fixed date conformity states are assumed to update their conformity to the IRC to January 1, 2018 while rolling conformity states will update automatically. Additionally, if a state is currently decoupled from an IRC section, they are assumed to continue to decouple from the same provision post-TCJA. For example, if a state currently decouples from federal bonus depreciation provisions, it is assumed to continue to remain decoupled from the new federal bonus depreciation provisions.

In actuality, fixed date conformity states may not update their conformity dates for several years. In those states, the actual experience may differ substantially from the forecasts in this analysis. Nevertheless, to estimate the potential magnitude that widespread conformity with the new federal tax rules will have on overall state corporate tax bases, this analysis assumes these states will update their conformity dates immediately.

Assuming an immediate update of the conformity date to the IRC as it exists on January 1, 2018, Table 3 describes the assumptions made in this analysis regarding state conformity to each referenced IRC Section and corresponding updated provision.

Table 3. Summary of assumptions regarding state conformity with major federal tax reform provisions

Provision	State conformity assumptions
Net interest expense limitation (IRC Section 168(j))	▸ All states levying a corporate income tax conform to this change with the exception of Mississippi which relies on a state-specific definition of interest.
Bonus depreciation provided under IRC Sections 168(k) and immediate expensing under IRC Section 179	▸ Many states explicitly add back federal bonus depreciation amounts and immediate expensing under IRC Sections 168(k) and 179, respectively. Of those that do not, 15 states conform to federal bonus depreciation provided under IRC Section 168(k) and 37 states conform to immediate expensing provided under IRC Section 179. See Figure 3 and Figure 4 for the state by state conformity assumptions to these IRC Sections for purposes of this analysis. Conformity to these Sections is assumed to remain the same after TCJA.
Like kind exchange changes (IRC Section 1031)	▸ All states levying a corporate income tax conform to this change
Net operating losses (IRC Section 172)	▸ Most states have their own net operating loss rules. States may conform separately to carryback period, carryforward period, and NOL amounts although a significant number do not allow a carryback for years prior to January 1, 2018. Most states have previously decoupled from federal carryback provisions and many do not reference IRC Section 172(b) in determining their carryforward period. Additionally, most states do not reference the federal limitation in computing the net operating loss amount. Therefore, although there may be minor impacts from this TCJA provision, no impact is assumed for this analysis.
Domestic and foreign dividends received deduction (DRD) (IRC Sections 243 and 245)	▸ Most states apply their own DRD rules. States are assumed to follow their pre-TCJA DRD rule. ▸ Most states provide a deduction or exclusion for foreign dividends. Seven states currently tax 30% or more of a taxpayer's foreign source dividends from wholly-owned subsidiaries. These states, plus several imposing tax on a smaller share of foreign dividends, are assumed to be impacted by this provision.

Provision	State conformity assumptions
Amortization of research and experimentation expenditures (IRC Section 174)	▸ All states levying a corporate income tax are assumed to conform to this change.
Domestic production deduction (IRC Section 199)	▸ 19 states conform to IRC Section 199 and are assumed to be impacted by the elimination of the deduction.
Transition tax (IRC Section 965)	▸ States vary widely in their treatment of Subpart F income upon which the new, one-time transition tax is based. Few states tax all of Subpart F income, although several states include a portion of Subpart F income based on ownership levels. This analysis assumes that states will tax the amount of unrepatriated earnings included under IRC Section 965(a) net of the deduction for a portion of those earnings provided under IRC Section 965(c) as Subpart F income, with the same exclusions and deductions that apply to their current Subpart F provisions or "deemed" Subpart F provisions (e.g., limited dividend received deductions). Note that in any state where state taxes are assumed to apply to this income, the deduction is also assumed to apply. See Figure 7 for assumptions regarding potential taxation of transition tax income.
Global Intangible Low Taxed Income (GILTI) (IRC Section 951A (and corresponding deduction provided in IRC Section 250))	▸ It is assumed that GILTI income will be included in income reported on Form 1120 line 28 and will be included in state taxable income in most states. The federal provision itself recognized that while GILTI will be treated "similarly" to Subpart F income, it is not Subpart F income. In general, this analysis assumes that the GILTI inclusion amount will be included in virtually all states. However, four states specifically provide an exclusion of income included by IRC Sections 951-964 and are therefore assumed to exclude GILTI levied under IRC Section 951A. ▸ States are assumed to conform to the 50% deduction (37.5% in later years) provided under IRC section 250 to the extent GILTI income is included in the state tax base.
Foreign Derived Intangible Income (FDII) (IRC Section 250)	▸ The analysis assumes that states will conform to the FDII deduction.
Base Erosion Anti-Abuse Tax (BEAT) (IRC Section 59A)	▸ BEAT is a new federal corporate tax on a different tax base (i.e., the "base erosion minimum tax amount") and does not impact the determination of the federal corporate income tax base that serves as the starting point for state corporate income tax returns of all states with a corporate income tax. No states are assumed to conform to this provision.

Interest limitation, R&E amortization, like-kind exchange, fringe benefits. Among the various provisions in TCJA, several have near-universal conformity at the state level. These provisions include the limitation on interest deductions, amortization of R&E expenditures, changes to like kind exchange rules for personal property, and limitations on the deductibility of certain employment fringe benefits. States generally do not require these deductions to be added back to federal corporate income when calculating the state corporate income tax base. Taken together, these provisions expand the federal tax base by an estimated 10%. *This analysis assumes that all states levying a corporate income tax will conform and are impacted by these TCJA provisions except Mississippi, which uses a state-specific definition of interest expense.*

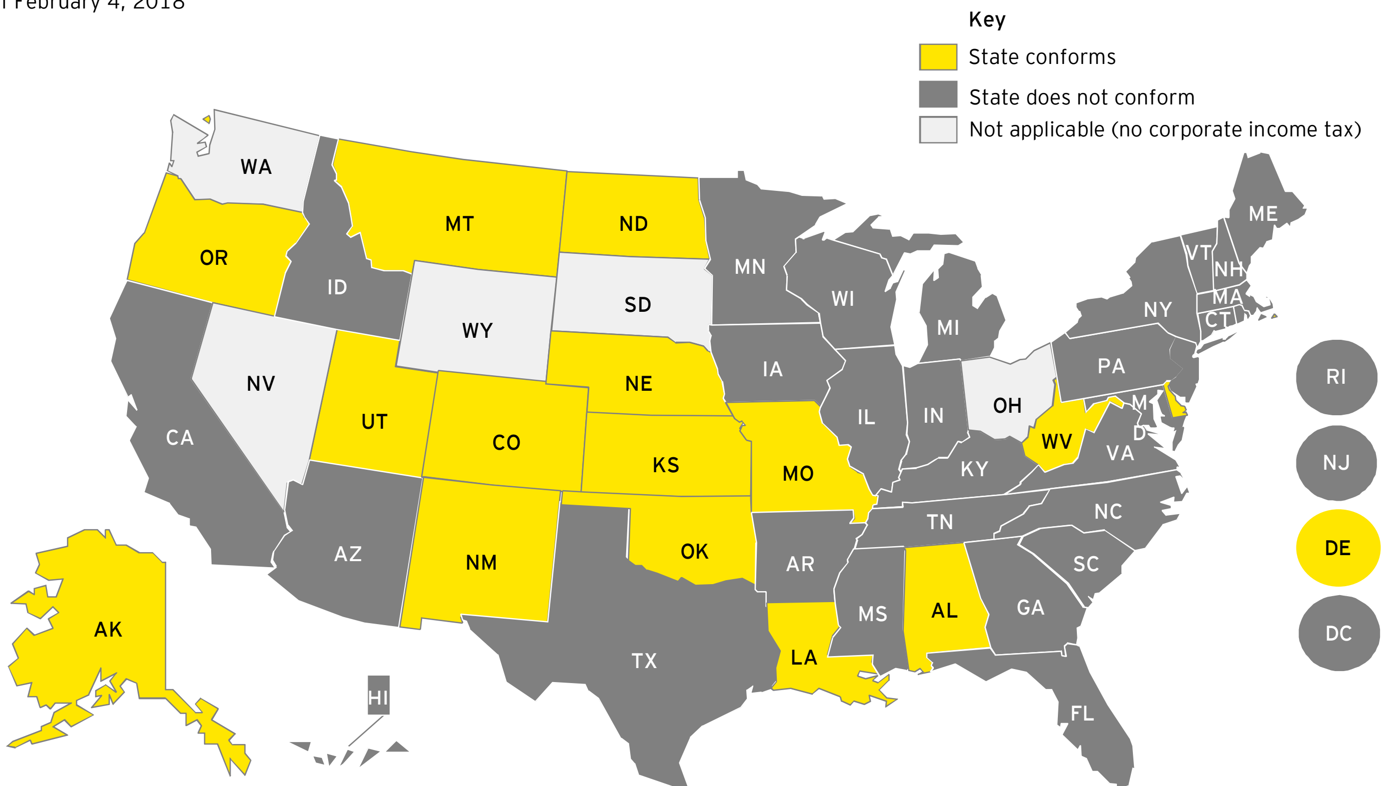
Net operating loss changes. The elimination of federal net operating loss carryback, the extension of the net operating loss carryforward period, and the limitation of the net operating loss deduction to 80% of income expands the federal tax base by an estimated 5.3% during the 10-year federal budget window. However, at the state level, most states have decoupled from net operating loss carryback provisions and those that conform to the federal carryforward period generally do not conform to the limitation on the amount of loss deductions that can be claimed. As a result, in many states, the only impact that might occur results from conformity of the state carryforward period to IRC Section 172(b), which previously provided a 20-year carryforward and now provides that net operating losses can be carried forward

indefinitely. While the tax base may be impacted in certain states, *this analysis assumes no impact* due to the lack of a separate federal estimate of the budgetary impact of the carryforward extension.

Expensing of capital assets. Two TCJA provisions impact the way corporate taxpayers depreciate property. The first and more significant provision based upon the JCT analysis is the expansion of bonus depreciation provided under IRC Section 168(k). The JCT estimates that this provision alone reduces the federal corporate tax base by 1.8% over the 10-year federal budget window. Figure 3 illustrates state conformity with this provision and shows that 15 states currently conform and would be impacted by IRC Section 168(k), including those whose conformity dates are assumed to be immediately updated. An additional TCJA depreciation-related provision is the change to IRC Section 179, which provides for immediate expensing of certain property for small businesses. 37 states conform fully to IRC Section 179 while other states impose limits on the amount of deduction that can be claimed. *This analysis assumes there is no tax base impact in states that impose a limit on IRC Section 179*.

Figure 3. State conformity with bonus depreciation provided under Section 168(k)

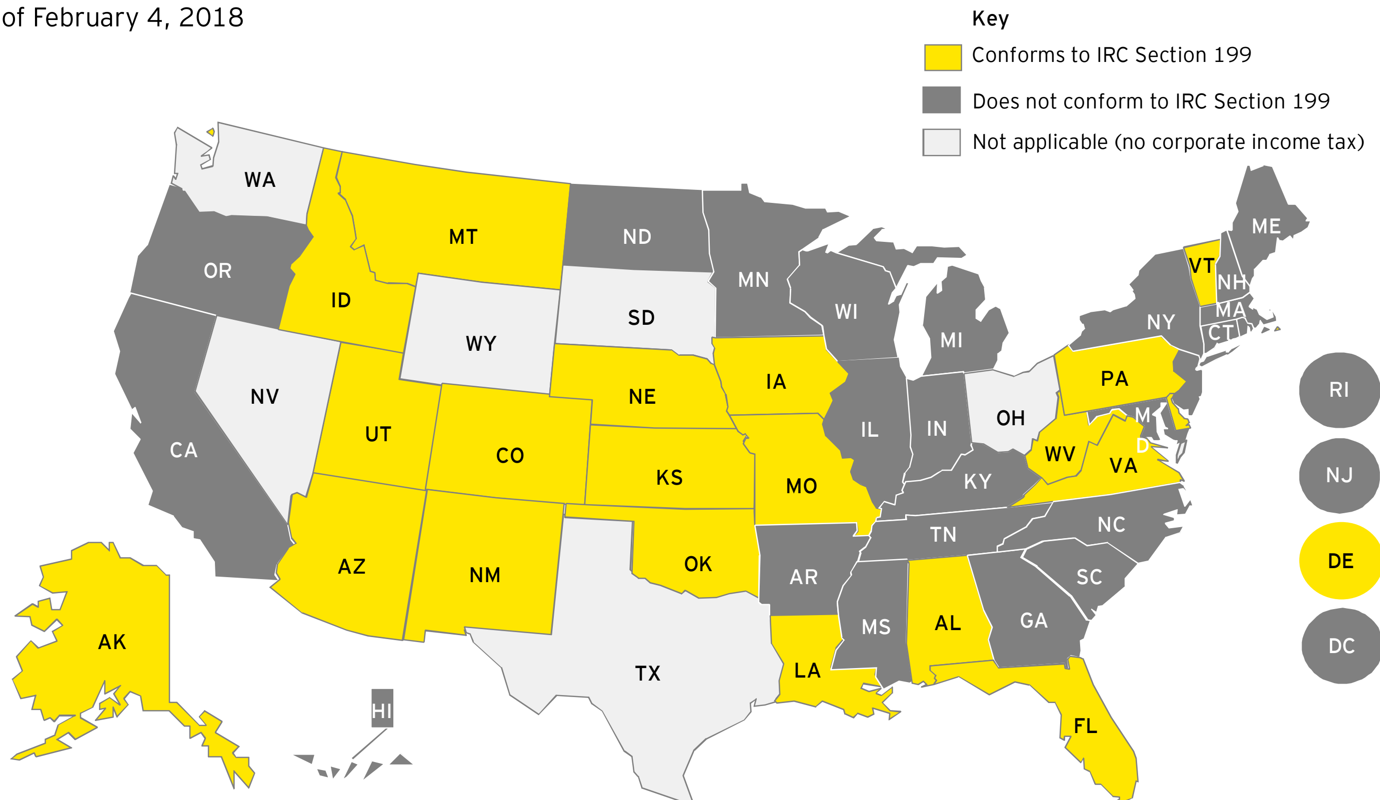
As of February 4, 2018



Domestic production activities deduction (Section 199). TCJA repeals the Section 199 deduction for domestic production activities, increasing the federal corporate income tax base by an estimated 1.9%. Roughly two-thirds of the Section 199 deduction is taken by the manufacturing sector, making conformity in industrial states more significant in terms of the overall impact on state corporate income tax bases. 19 states are assumed to conform with the federal provision although many manufacturing-heavy states in the Midwest and Southeast do not conform.

Figure 4. Conformity with Domestic Production Activities Deduction (IRC Section 199)

As of February 4, 2018



Global Intangible Low Taxed Income (GILTI). At the federal level, this provision imposes a tax on high-returns of controlled foreign corporations of US corporate shareholders. The provision is structured to include the entire amount of GILTI income at a 21% tax rate (under IRC Section 951A) but also includes a corresponding deduction under IRC Section 250 for a portion of the included GILTI income (the GILTI deduction is 50% through 2025 dropping to 37.5% thereafter). The effect of the inclusion and deduction reduces the federal effective tax rate for GILTI income to 10.5% immediately and 13.125% after 2025.

The analysis in general assumes that GILTI **will be included** in the income reported by US corporate shareholders on Form 1120 line 28 and would therefore be included in the taxable income base for most states. However, the mechanism used by certain states to exclude Subpart F income (either by treating Subpart F income as deemed dividends subject to the state's DRD or as excludable from state taxable income otherwise) becomes important in determining the amount of GILTI income subject to state tax. Moreover, as GILTI is not specifically defined even for federal income tax purposes as Subpart F income, it is not entirely clear that the states would subject GILTI to the same treatment.[9] Additionally, ownership of controlled foreign corporations generating the GILTI income is likely to be concentrated in holding companies that may be located in states providing favorable tax treatment.[10] Four states

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[9] In its preliminary report to the state's governor on the impact of the TCJA, the New York Department of Taxation and Revenue had this to say about GILTI income: "Although this new GILTI income is treated similarly to Subpart F income, it is specifically not characterized as Subpart F income under the IRC and therefore would not qualify as other exempt income. Thus, the income would flow through to New York, be treated as business income, and be subject to tax." N.Y.S Dept. of Tax. & Fin. *Preliminary Report on The Federal Tax Cuts and Jobs Act* pg. 30 (Jan. 2018) (available on the Internet at https://www.tax.ny.gov/research/stats/stat_pit/preliminary-report-tcja-2017.htm (last accessed Feb. 4, 2018) (the "NY Report")). [Ed. In immediately preceding pages, the NY Report previously pointed out that Subpart F income was explicitly treated as "exempt income" under New York's corporate tax law and thus, not taxable.]

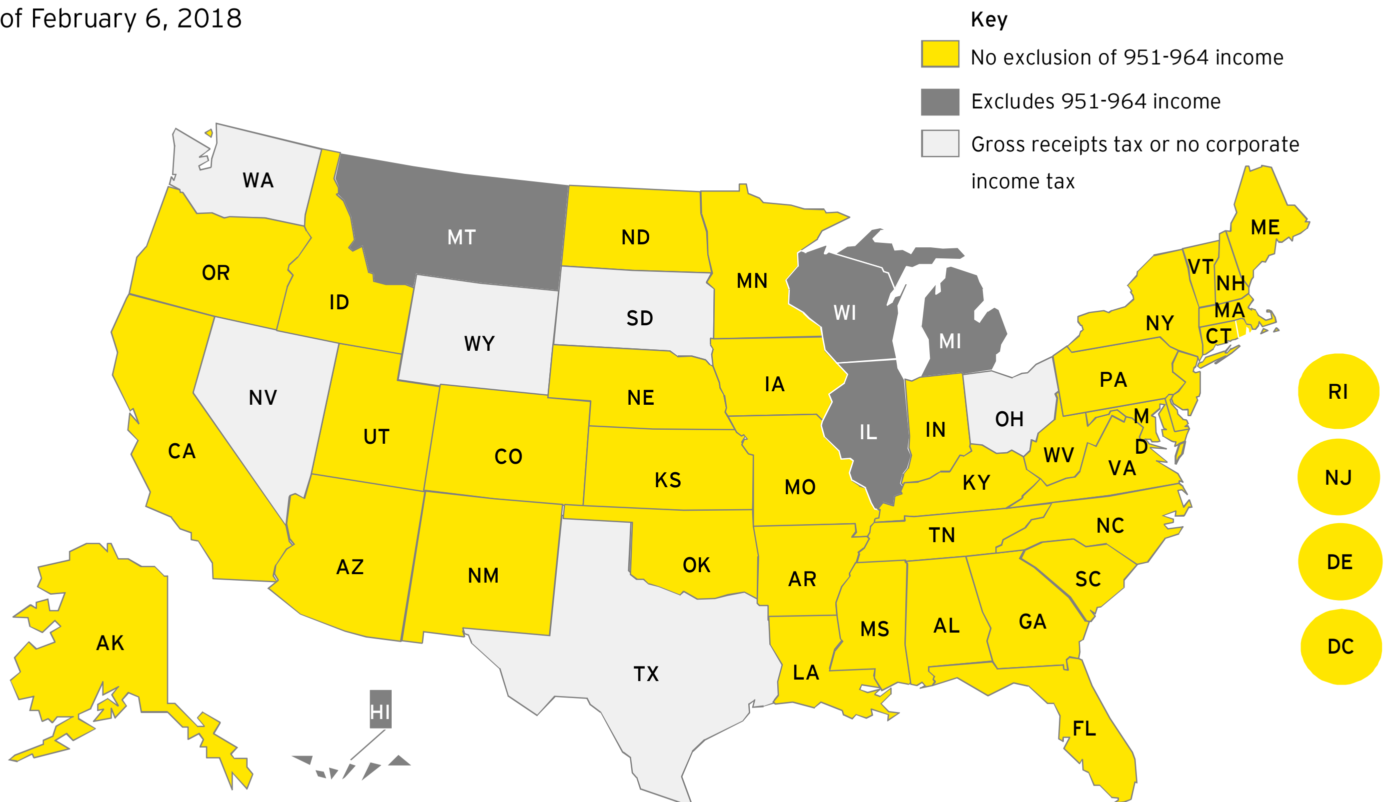
[10] GILTI may be recognized by corporations that have limited nexus footprints (e.g., pure holding companies whose only assets consist of stock of subsidiaries and thus, would likely only have nexus in their state of incorporation and be includible only in unitary combined or consolidated

provide a subtraction for income included in federal income under IRC Sections 951-964. GILTI, which is included in income under IRC Section 951A, will likely be an allowable subtraction from income in these states.[11]

This analysis assumes the deduction provided under IRC Section 250 will be considered in the calculation of Form 1120 line 28 income, meaning it will be reflected in all states to the extent GILTI income is taxable in those states. This assumption is based, in part, on the interpretations to of states, such as New York and Minnesota, which have indicated in their revenue estimates they will conform to IRC Section 250.[12] There is still great uncertainty over whether states, particularly those currently linking to Line 28 of the federal tax return, will conform to the new IRC Section 250 deductions. IRC Section 250 is located in Part 8 of the Internal Revenue Code entitled "Special Deductions." In the Form 1120, Special Deductions are reflected in line 29b. However, several Line 28 states still conform to the Line 29b deductions through adoption of specific items.

Figure 5 shows the assumed state treatment of GILTI income as it relates to the entire income inclusion portion of GILTI (IRC Section 951A). States shown as excluding GILTI income are assumed to have no impact from this provision. States shown as not excluding GILTI income are generally assumed to include GILTI income net of deduction (IRC Section 250). If states decouple from the GILTI deduction, the tax base in those states would be approximately 2.6% higher on average.

Figure 5. Potential taxation of GILTI income (inclusion)



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returns), although determinations regarding nexus vary and are subject to aggressive state challenges. Further, states may assert IRC Section 482 powers to redistribute items of income between related entities, as well as other challenges that could limit the impact of holding companies with GILTI income.

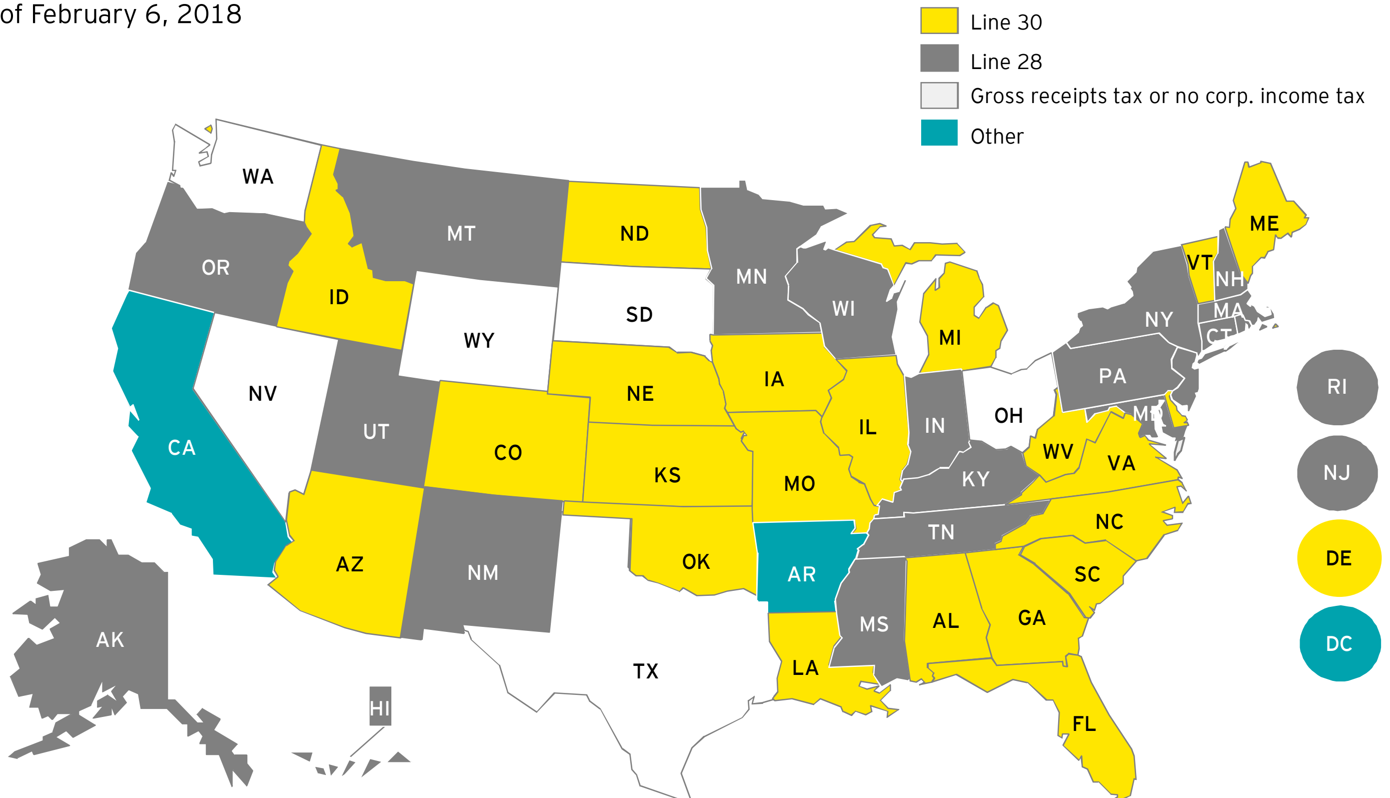
[11] Note that subtractions for income included in federal tax base under IRC Section 951 are assumed not to be sufficient to exclude GILTI income from the tax base since GILTI is imposed under IRC Section 951A which is NOT incorporated into IRC Section 951(a)'s listing of the items includable in Subpart F income.

[12] N.Y.S Dept. of Tax. & Fin. *Preliminary Report on The Federal Tax Cuts and Jobs Act* pg. 30 (Jan. 2018) (available on the Internet at https://www.tax.ny.gov/research/stats/stat_pit/preliminary-report-tcja-2017.htm (last accessed Feb. 4, 2018); State of Minnesota, Federal Update: The Tax Cut and Jobs Act of 2017 As Enacted (available on the Internet at http://www.revenue.state.mn.us/research_stats/revenue_analyses/2017_2018/Federal%20Update%20Tax%20Cuts%20and%20Jobs%20Act%20 2017_5.pdf)

Foreign-Derived Intangible Income (FDII) Deduction. IRC Section 250 provides a new deduction for certain income earned by US taxpayers from foreign sources, referred to as foreign-derived intangible income. It is not yet clear whether this deduction will appear before or after Form 1120 line 28, which may be a factor in how states reflect these items. Figure 6 shows state income starting points and, specifically, whether the state starts with line 28 or line 30 from the federal Form 1120. However, this analysis assumes the deduction will be available to taxpayers in all states, regardless of state starting point. This assumption is based on the interpretation of states in their revenue estimates, including New York and Minnesota, that they will conform to IRC Section 250.[13] If states decouple from the FDII deduction, the tax base would be higher in those states by approximately 1.7% on average.

Figure 6. State income starting point

As of February 6, 2018



Transition tax. To move the US from a worldwide to a territorial system of taxing multinational businesses, IRC Section 965 imposes a federal "transition tax" by including all of the post-1986 earnings of certain foreign subsidiaries of a US shareholder as a special classification of Subpart F income. The provision allows for the netting of the earnings and profits (E&P) deficits and surpluses of foreign corporations owned by a US shareholder. The amounts are reportable on the last return of the foreign corporations for tax years beginning before January 1, 2018.

Most states provide a subtraction or exclusion for Subpart F income, as shown in Figure 7, meaning that amounts includable in federal income due to the transition tax will generally not be taxed by the states. However, four states (i.e., Colorado, New Hampshire, Oklahoma, and Vermont) do not provide a deduction or modification for Subpart F income and may impose their taxes on the federal amounts reported under IRC Section 965. In many other states, tiered deductions are provided for Subpart F income based on ownership levels. This analysis assumes that income subject to tax under this provision was earned by a 100%-owned entity and would be subject to the maximum exclusion percentage. Given this assumption, four states may fully tax income determined under IRC Section 965 and another 12 states may impose tax on a fractional portion of this income.

Finally, there may also be an indirect revenue pickup in several other states. For example, in California, once the deemed repatriated earnings have been actually distributed as dividends to U.S. corporate shareholders, there will be

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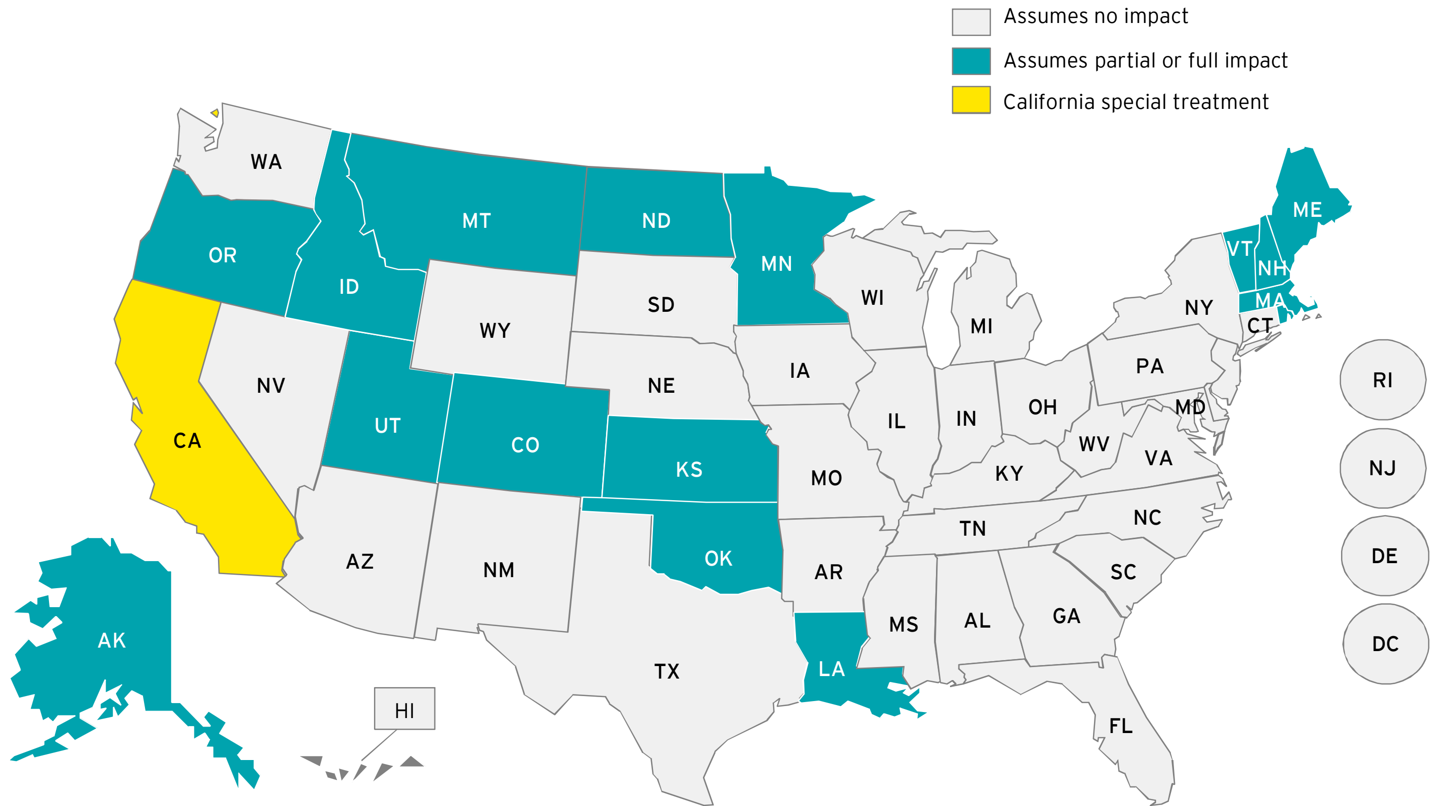
13 *Ibid.*

an impact for waters-edge filers. California has estimated this amount at approximately $350 million.[14] Moreover, other states may disallow expenses related to non-taxable foreign dividends. Neither of these impacts have been included in the estimated corporate tax base increases presented in Table 5.

Base Erosion Anti-Abuse Tax (BEAT). The BEAT is a federal minimum tax, which is generally levied on a tax base which disallows subtractions for certain categories of payments to affiliates. As a separate tax, rather than an adjustment to the federal tax base reported on Form 1120 line 28 or line 30, there is no anticipated impact of BEAT on state corporate income tax bases.

Figure 7. Potential state taxation of accumulated foreign earnings



[14] See Cal. Franchise Tax Board, Preliminary Report on Specific Provisions of the Federal Tax Cuts and Jobs Act (available on the Internet at https://www.ftb.ca.gov/aboutFTB/newsroom/Preliminary-Review-of-Federal-Tax-Reform-Part-1.pdf (last accessed February 23, 2018)).

6. Industry impacts of the TCJA on federal and state corporate tax bases

Impacts of the TCJA vary by industry based on the tax and financial profiles of companies in each industry sector. Given the variation in the distribution of industry activity across states, this variation in the impact of the TCJA by sector is significant in understanding the impact on state corporate income tax bases. To reflect this variation, the estimated economy-wide changes in the federal tax base shown in Table 2 are allocated to national industry sectors using relevant data from the IRS *Statistics of Income (2014), Bureau of Economic Analysis* (2016), and financial databases including Audit Analytics and S&P Compustat (2016). The industry sector impact allocation approach varies by provision, but generally involves identifying a logical allocation item (*e.g.*, debt for interest limitation, fixed assets for bonus expensing, accrued foreign earnings for transition tax). For most provisions, the allocation of taxable income by industry is derived from a data series describing the US federal tax base. For instance, the estimate of a one-time tax on un-repatriated foreign earnings of US multinational corporations is allocated using industry shares of permanently reinvested foreign earnings from 2016 Audit Analytics microdata.

In some cases, adjustments are made to account for provisions that apply to specific industry sectors. For instance, under the TCJA, electric, water, and gas utility companies that are regulated by public utility commissions may elect to not receive bonus depreciation and retain full deductibility of net interest. Therefore, the estimated impact of bonus depreciation and net interest limitations on the utilities industry is relatively minor. Similarly, because the insurance industry is generally taxed by states' premium tax systems rather than state corporate income taxes, the effects on the insurance industry sector of the TCJA are excluded entirely from this analysis.

This analysis reflects only the impacts on C corporations. However, some provisions of the TCJA apply to both pass-through entities (such as partnerships, sole proprietors (and including in both cases, LLCs) and S corporations) and C corporations and the JCT reported only a combined revenue impact for all types of business entities. For these types of provisions, separate data from the IRS Statistics of Income, for Forms 1065, 1120, and 1120S are used to distribute impacts between C corporations and pass-through entities.[15] Where IRS data are unavailable or insufficient, the analysis uses tax expenditure estimates from the JCT, which attributes items to corporations and individuals. Most IRS data tables contain data from taxable year 2014 or earlier, whereas JCT tax expenditure estimates are available for taxable years 2016 through 2020.[16]

EY has estimated the change in the federal corporate tax base by industry sector under the various provisions of the TCJA shown in the first column of Table 4 below. Overall, the provision which most significantly increases taxable income in the 10-year federal budget window is the transition tax, which raises federal corporate taxable income across all industry sectors by 9% over the 2018-2027 period. The business interest expense limitation and the NOL limitations each increase federal corporate taxable income by roughly 6% while the move to a territorial system will decrease federal corporate taxable income by 6%. The largest expansions in federal corporate tax base arise in the manufacturing and capital-intensive service industry sectors due primarily to the transition tax. The finance and holding company sector will be impacted mostly by the impact of the federal NOL limitations and the transition tax and GILTI. The labor-intensive service sector will see the smallest overall increase in federal taxable income. While it is somewhat affected by the transition tax and the business expense interest limitation, it benefits almost equally from the expansion of bonus depreciation and the move to a territorial tax system.

The estimated federal impacts for each industry by provision are considered in conjunction with each state's conformity rules to determine the impact on the corporate tax base by industry, by state. These results are then weighted in each state by each industry's share of statewide private-sector GDP to calculate the overall impact on each state. For example, as shown in Table A-1, the Alabama manufacturing industry accounts for 21% of statewide private-sector GDP, capital intensive services account for 22%, labor intensive services for 38%, etc. These shares are applied to the results for each industry in Alabama after applying conformity rules to estimate the overall impact of the TCJA on Alabama. The overall impact on industries is estimated using the process above in each state. The state results are then combined into an overall nationwide average by weighting by state corporate tax base.

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[15] Data from IRS Forms 1120L, 1120-PC, 1120-REIT, and 1120-RIC for 2014 was also used to allocate taxable income.

[16] These estimates were produced in 2017 and likely relied on 2015 IRS microdata.

The second column of Table 4 shows the federal corporate tax base expansion estimated to impact states, considering the state conformity rules in each state, the mix of industry sectors in each state, and the size of the corporate income tax base in each state.

Table 4. Estimated industry change in federal and state tax base by sector
(% increase in US corporate tax base by industry, 2018-2027)

Industry Sectors (C Corporations only)	Estimated federal corporate tax base expansion from major provisions	Estimated state corporate tax base expansion from major provisions
Manufacturing sector	23%	12%
Capital intensive service sector (transport, information, utility, real estate)	29%	17%
Labor intensive service sector (trade, professional and personal services)	10%	9%
Finance and holding company sector	18%	8%
Other industries sector (agriculture, mining, construction)	23%	13%
Overall change for all industries from major provisions	**19%**	**12%**

Source: Based on analysis contained in Brandon Pizzola, Robert Carroll, and James Mackie, "Analyzing the revenue effects for businesses and key industries under the Tax Cuts and Jobs Act," EY Quantitative Economics and Statistics, forthcoming.

7. State corporate tax base impacts of the TCJA

The impacts of the TCJA on each state's revenue base will vary based on four factors: (1) the state's conformity rules, (2) the state's methodology of imposing a corporate income tax on C corporations (e.g., combined vs. separate company reporting); (3) the composition of taxpayers by industry sector in the state, and (4) the impact of the TCJA provisions on each industry sector. This section presents the estimated impact of the TCJA on state corporate income tax bases given these factors.

As shown in Table 5, the impact of the TCJA on state corporate income tax bases over the 10-year period varies substantially by state depending on each state's conformity rules and industry mix. In general, states with the lowest estimated tax base expansion are those which provide an explicit exclusion of GILTI income and which exclude 100% of Subpart F income. The 12% overall change figure in Table 5 is calculated as the result for each state, weighted by the estimated state corporate net income tax base of each state.[17]

The estimates presented in Table 5 assume that all states will conform to new federal deductions for FDII and GILTI provided under IRC Section 250, which reduce the corporate net income tax base by approximately 4% nationwide. [18] However, there is still great uncertainty over whether states, particularly those currently linking to Line 28 of the federal tax return, will conform to the new IRC Section 250 deductions. To the extent a state does not conform to IRC Section 250 (but link to the GILTI income inclusion), its corporate tax base expansion would be higher than the results reported in this analysis by approximately 4%.

Although not considered in this analysis, states without significant impacts from the one-time deemed repatriation that will occur on returns for tax year 2017 as a result of the transition tax provision (IRC Section 965) may be impacted when accumulated foreign earnings are actually repatriated. For example, there may be significant California impacts from cash repatriations by waters'-edge filers, even if the one-time distribution is not included on the 2017 state return.

Over the 10-year period shown in Table 5, the impacts on state corporate tax bases will vary by year. During the first four years, the average expansion in the state corporate tax base is estimated to be 8%, which increases to 13.5% from 2022 to 2027. This increase in the later years is primarily due to the impact of R&E expense amortization (which begins in 2022) and the change in interest expense limitation (which occurs in 2022).

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[17] The corporate state net income tax base in each state is estimated by dividing the total corporate net income tax collections in each state for FY2016, as reported by the US Census Bureau by the state statutory corporate tax rate.

[18] While there has been no guidance provided by the Internal Revenue Service regarding the placement of the new Section 250 deductions on the federal Form 1120, the analysis assumes all states will conform to the deduction to the extent the related income is included in the state corporate tax base.

Table 5. Impact of TCJA on state corporate income tax bases assuming updated conformity to January 1, 2018 US IRC
(% increase in US corporate tax base by industry, 2018-2027)

State	% increase in state corporate tax base	State	% increase in state corporate tax base
Alabama	11%	Nebraska	11%
Alaska*	12%	Nevada	n/a
Arizona	14%	New Hampshire*	13%
Arkansas	12%	New Jersey*	12%
California**	12%	New Mexico*	11%
Colorado	12%	New York*	12%
Connecticut*	12%	North Carolina	12%
Delaware	10%	North Dakota	10%
Florida	13%	Ohio	n/a
Georgia	12%	Oklahoma	13%
Hawaii*	13%	Oregon*	10%
Idaho	9%	Pennsylvania*	14%
Illinois	9%	Rhode Island*	11%
Indiana*	12%	South Carolina	12%
Iowa	13%	South Dakota	n/a
Kansas	11%	Tennessee*	12%
Kentucky*	12%	Texas	n/a
Louisiana	12%	Utah*	12%
Maine	12%	Vermont	14%
Maryland*	12%	Virginia	13%
Massachusetts*	12%	Washington	n/a
Michigan	9%	West Virginia	9%
Minnesota*	12%	Wisconsin*	9%
Mississippi*	4%	Wyoming	n/a
Missouri	11%	District of Columbia	12%
Montana*	9%	**Overall change**	**12%**

Source: Ernst & Young LLP analysis

Note: states indicated as "n/a" do not impose a corporate net income tax. The overall change is calculated as the weighted average change across all states levying a corporate net income tax; in this calculation, states are weighted by their corporate net income tax base, which is calculated by dividing state corporate tax collections as reported by the US Census Bureau for FY2016 by the statutory corporate tax rate in each state.

* State starts with Form 1120 line 28. To the extent IRC Section 250 deductions are not allowed, this impact would be higher by approximately 4%.

** There may be a California impact relating to cash repatriation for waters-edge filers once the deemed repatriated earnings have been actually distributed as dividends to U.S. corporate shareholders. California has estimated this amount at approximately $350 million. See https://www.ftb.ca.gov/aboutFTB/newsroom/Preliminary-Review-of-Federal-Tax-Reform-Part-1.pdf

Table 6 shows the estimated share of the federal tax base expansion resulting from various TCJA provisions that is expected to impact state corporate tax bases, considering conformity rules and the composition of industries within each state. Certain items such as interest limitations, amortization of R&E expenses, fringe benefit deduction changes, and changes to the like-kind exchange rules are expected to impact the state corporate tax base in a manner similar to the federal corporate tax base because these items appear in Form 1120 line 28 net income without state modification. However, fewer states conform to certain federal tax base changes, such as the domestic production activity deduction and bonus depreciation provided under IRC Section 168(k). Considering the level of tax base change by industry, as well as the conformity rules and industry mix of each state, the share of the federal tax base change that will impact state tax bases is estimated to be approximately 60%.

Table 6. Assumed state-level impact of specific TCJA provisions, as a percentage of federal corporate income tax base change, assuming updated conformity to January 1, 2018 US IRC (for each provision, state corporate tax base change divided by estimated federal tax base change for the 2018-2027 period)

TCJA provision	Share of federal corporate tax base change potentially impacting state corporate tax bases
Interest limitation	99%
NOL changes	0%
Amortization of R&E expenditures	100%
Domestic Production Activities Deduction	24%
Fringe benefits deduction limitation	100%
Like-kind exchange changes	100%
Base erosion and anti-abuse tax (BEAT)	0%
Transition tax	6%
Global Intangible Low Taxed Income (GILTI) inclusion	88%
Global Intangible Low Taxed Income (GILTI) deduction*	88%
Foreign Derived Intangible Income (FDII)*	100%
Foreign dividends received deduction*	7%
Small business accounting method changes	100%
Bonus depreciation provided under IRC Section 168(k)	11%
Bonus depreciation provided under IRC Section 179	66%
All provisions	**60%**

Source: Ernst & Young LLP analysis

* As noted elsewhere in the text, there remains considerable uncertainty about the way in which IRC Section 250 deductions will be implemented and conformed to by state. See the discussion about state conformity to IRC Section 250 in section 6 of this report.

8. Important assumptions and limitations of the analysis in this study

This analysis is limited in several ways that may be material to the results. Please note the following limitations and assumptions.

- It is unknown when a state with fixed conformity will update its conformity date to the IRC. This analysis assumes that all states will conform to the IRC as of January 1, 2018. The estimates presented for the 10-year period covered in this analysis may therefore be reduced to the extent fixed conformity states do not immediately update their IRC references.
- States may choose to decouple from revenue reducing provisions while remaining coupled to revenue raisers. This analysis assumes no changes in conformity to specific IRC sections other than updating dates. Additionally, states are still clarifying their interpretation of existing conformity rules as they apply to the new federal provisions. States may interpret the conformity rules differently than the assumptions included in this study.
- States are rapidly estimating the impacts of federal tax reform on their tax base and many are introducing legislation to update and, in some cases, change areas of conformity with the IRC. This study incorporates the conformity rules as they existed at the time the analysis was conducted, but in this rapidly changing state tax environment, the assumptions used in this analysis may become superceded in particular states. Other differences with individual state estimates may arise because of variations in the years encompassed by the analysis (e.g., 1, 3-5, 10 year periods).
- Location of US shareholders receiving "deemed" repatriated earnings or GILTI income may be concentrated in holding companies that do not have nexus in all states. For purposes of this analysis, all such shareholders are assumed to be unitary with their combined reporting group. No adjustments have been made for any potentially different outcomes in separate company reporting states.
- The analysis assumes tax base expansion in certain states as a result of conformity with the international provisions of the TCJA. However, strong US and state constitutional and other tax policy arguments could influence state tax policymakers to choose to not conform to various new international tax provisions brought about under the TCJA, such as the transition tax, GILTI, FDII or BEAT for state tax purposes.
- Actual implementation of certain provisions of the TCJA for federal income tax purposes is still unknown for several important provisions (e.g., whether the 30% interest expense limitation will be determined on a consolidated basis and if so, how the allocation of the limitation so determined will be allocated among the members of the consolidated group.) These details may impact the way in which each provision of the TCJA impacts the state corporate revenue bases.
- State estimates are weighted by the size of the corporate tax base in each state to compute the US average change in state corporate tax base. Within each state, the results by industry are weighted by the industry's share of GDP to compute the overall change by state. Weighting by GDP within each state assumes the same level of corporate taxable net income per dollar of GDP, which may not be accurate.
- The analysis considers only changes in the corporate tax base. The TCJA also includes many changes to the individual income tax base and to certain items that affect passthrough entities. Neither of these categories of changes is included in the analysis.
- The analysis only considers the major federal tax reform provisions described in this report. There are other provisions which have not been analyzed. For certain industries and potentially for certain states, these provisions may be material.

9. Appendix: Supplemental information

Table A-1. Industry shares of state gross domestic product by industry

State	Manufacturing	Capital intensive services	Labor intensive services	Finance and holding companies	Other sectors	Total
Alabama	21%	22%	38%	8%	11%	100%
Alaska	4%	33%	31%	4%	28%	100%
Arizona	10%	27%	43%	10%	10%	100%
Arkansas	17%	24%	38%	10%	12%	100%
California	13%	33%	38%	7%	9%	100%
Colorado	8%	28%	41%	9%	14%	100%
Connecticut	12%	26%	39%	17%	6%	100%
Delaware	7%	21%	29%	37%	6%	100%
Dist. of Columbia	0%	24%	57%	7%	12%	100%
Florida	6%	29%	47%	9%	10%	100%
Georgia	12%	29%	39%	12%	8%	100%
Hawaii	3%	36%	43%	6%	12%	100%
Idaho	13%	23%	42%	6%	16%	100%
Illinois	14%	24%	40%	14%	8%	100%
Indiana	32%	18%	33%	8%	9%	100%
Iowa	21%	19%	30%	18%	13%	100%
Kansas	17%	22%	39%	10%	12%	100%
Kentucky	22%	22%	37%	8%	11%	100%
Louisiana	23%	21%	36%	6%	14%	100%
Maine	11%	24%	47%	9%	9%	100%
Maryland	7%	32%	43%	9%	9%	100%
Massachusetts	11%	25%	44%	13%	7%	100%
Michigan	21%	21%	41%	9%	8%	100%
Minnesota	16%	22%	39%	13%	10%	100%
Mississippi	19%	23%	39%	7%	11%	100%
Missouri	15%	23%	41%	12%	9%	100%
Montana	9%	26%	40%	6%	18%	100%
Nebraska	13%	25%	33%	16%	14%	100%
Nevada	5%	27%	49%	9%	11%	100%
New Hampshire	12%	24%	44%	13%	7%	100%
New Jersey	9%	29%	44%	11%	7%	100%
New Mexico	6%	28%	41%	6%	20%	100%
New York	5%	29%	38%	22%	6%	100%
North Carolina	23%	21%	36%	12%	8%	100%
North Dakota	8%	25%	33%	7%	27%	100%
Ohio	19%	21%	37%	14%	9%	100%
Oklahoma	11%	24%	36%	6%	22%	100%
Oregon	25%	24%	34%	9%	9%	100%
Pennsylvania	13%	27%	39%	11%	10%	100%
Rhode Island	9%	24%	44%	16%	7%	100%
South Carolina	20%	23%	40%	7%	10%	100%
South Dakota	10%	18%	37%	19%	16%	100%
Tennessee	18%	22%	44%	8%	8%	100%
Texas	15%	21%	38%	8%	17%	100%
Utah	13%	25%	37%	13%	12%	100%
Vermont	11%	24%	48%	8%	10%	100%
Virginia	11%	27%	44%	9%	9%	100%
Washington	15%	32%	38%	6%	9%	100%
West Virginia	12%	21%	38%	5%	23%	100%
Wisconsin	20%	23%	35%	13%	9%	100%
Wyoming	8%	27%	27%	4%	34%	100%

Table A-2. Assumptions used in the analysis regarding state conformity with the IRC

Conformity	Interest limitation	R&E amortization	Section 199	Fringe benefit limitation	Like-kind exchange	Transition tax	GILTI inclusion	GILTI deduction	FDII deduction	Foreign dividend deduction	Small business accounting method	Section 168k	Section 179
Alabama	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	Full	Full
Alaska	Full	Full	Full	Full	Full	Partial	Full	Full	Full	Partial	Full	Full	Full
Arizona	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	None	Full
Arkansas	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
California	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
Colorado	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full
Connecticut	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	Full
Delaware	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	Full	Full
Florida	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	None	Full
Georgia	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	Full
Hawaii	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
Idaho	Full	Full	Full	Full	Full	Partial	Full	Full	Full	Full	Full	None	Full
Illinois	Full	Full	None	Full	Full	None	None	None	Full	None	Full	None	Full
Indiana	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
Iowa	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	None	Full
Kansas	Full	Full	Full	Full	Full	Partial	Full	Full	Full	Partial	Full	Full	Full
Kentucky	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
Louisiana	Full	Full	Full	Full	Full	Partial	Full	Full	Full	Partial	Full	Full	Full
Maine	Full	Full	None	Full	Full	Partial	Full	Full	Full	Partial	Full	None	Full
Maryland	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
Massachusetts	Full	Full	None	Full	Full	Partial	Full	Full	Full	Partial	Full	None	Full
Michigan	Full	Full	None	Full	Full	None	None	None	Full	None	Full	None	Full
Minnesota	Full	Full	None	Full	Full	Partial	Full	Full	Full	Partial	Full	None	Full
Mississippi	None	Full	None	Full	Full	None	Full	Full	Full	Full	Full	None	Full
Missouri	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	Full	Full
Montana	Full	Full	Full	Full	Full	Partial	None	None	Full	Partial	Full	Full	Full
Nebraska	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	Full	Full
Nevada	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
New Hampshire	Full	Full	None	Full	Full	Full	Full	Full	Full	Full	Full	None	Full
New Jersey	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
New Mexico	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	Full	Full
New York	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	Full
North Carolina	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None
North Dakota	Full	Full	None	Full	Full	Partial	Full	Full	Full	Partial	Full	Full	Full
Ohio	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Oklahoma	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full
Oregon	Full	Full	None	Full	Full	Partial	Full	Full	Full	Partial	Full	Full	Full
Pennsylvania	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	None	Full
Rhode Island	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	Full
South Carolina	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	Full
South Dakota	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Tennessee	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	Full
Texas	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	Full
Utah	Full	Full	Full	Full	Full	Partial	Full	Full	Full	Partial	Full	Full	Full
Vermont	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	None	Full
Virginia	Full	Full	Full	Full	Full	None	Full	Full	Full	None	Full	None	Full
Washington	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
West Virginia	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	Full	Full
Wisconsin	Full	Full	None	Full	Full	None	None	None	Full	None	Full	None	Full
Wyoming	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
District of Columbia	Full	Full	None	Full	Full	None	Full	Full	Full	None	Full	None	None

Source: Ernst & Young LLP research, Bloomberg BNA, Commerce Clearinghouse