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TAX ALERT

MARCH 15, 2018

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Ohio and multi-state tax impact from 2017 Federal Income Tax Law

Discussions of business tax changes under the 2017 federal tax act have focused on the reduction of the federal corporate income tax rate from 35 percent to 21 percent and the new 20 percent pass-through entity deduction. Less focus has been put on the expansion of the federal income tax base. Because most states start with federal adjusted gross income (AGI) or federal taxable income for their personal and corporate income tax systems, the expansion of the federal income tax base is likely to result in corporations and pass-through businesses (and their owners) paying more in state income tax absent a decrease in state income tax rates. Some studies have estimated the tax base expansion at between 7 percent and 14 percent, depending on the state.

Ohio imposes a "commercial activity tax" rather than a corporate income tax. However, all of Ohio's neighbors and most other states impose a corporate income tax. Moreover, individuals who own businesses operating in Ohio in pass-through structures – such as partnerships, most LLCs and S corporations – pay Ohio personal income tax.

Some states may consider legislation addressing federal tax reform, by either decoupling from all or certain federal income tax rules or by adjusting tax rates. Many states, however, are likely to see the expected additional revenue as a "gift" and use it to expand spending or reduce other taxes.

State and local tax deduction for individuals

Subject to certain phase-outs and the alternative minimum tax (AMT), in the past most taxpayers who chose to itemize deductions on their federal income tax return were permitted to deduct the entire amount of state and local personal property taxes, real property taxes and income taxes (and in certain situations, sales taxes) paid during the year. Beginning in 2018, taxpayers who itemize deductions may only deduct up to $10,000 in total of those same types of taxes. An exception exists for state and local property and sales taxes paid or accrued in connection with a trade or business taken on Schedule C or E: taxpayers may deduct the full amount paid or incurred of those amounts and it will not count towards the $10,000 personal limit. However, personal income taxes emanating from pass-through business are subject to the $10,000 limit. The limit on the deductibility of state and local taxes will expire after 2025.

Expensing and interest deductions

The political bargaining that produced the 2017 federal tax law resulted in an allowance of 100 percent expensing for many business investments, which decreases income tax revenue. This was paired with a new limitation on interest deductions, which increases income tax revenue.

Under prior federal income law, a business could receive a limited "bonus depreciation" deduction when it placed qualified property into service. Under the new law, bonus depreciation generally has been extended through 2026. The 2017 tax act has also temporarily increased the amount of bonus depreciation to 100 percent of the cost of assets acquired and placed into service after Sept. 27, 2017, and before Jan. 1, 2023.

Under prior law, outside of interest related to certain foreign borrowing transactions, businesses were not subject to significant interest deduction limitations at the federal law. Effective for 2018, the business interest expense deduction is limited to 30 percent of a business's AGI for the taxable year. Initially, AGI will not be reduced by interest, taxes, depreciation, amortization or depletion. Beginning in 2022, depreciation, amortization and depletion will reduce AGI, further reducing the allowable deduction. Small businesses with average annual gross receipts of $25 million or less for the immediately preceding 3-year period are exempt

from the business interest deduction limitation. There is also an opt-out for certain real estate businesses. Real estate businesses that opt-out are subject to longer depreciation schedules in exchange.

These dueling federal tax law changes were intended to incentivize business investment and expansion while discouraging the use of debt financing over equity financing.

At the state level, however, businesses might end up without the carrot (bonus depreciation) but with the stick (interest deduction limitations).

Absent new legislation at the state law, all or most states that have a corporate or individual income tax will conform to the interest limitation provisions. However, approximately two-thirds of the states currently opt out of bonus depreciation and, through state tax add-backs, are likely to not conform to the 100 percent bonus deprecation regime.

On balance, the new expensing provisions coupled with the new interest limitations are likely to increase state income tax revenue.

Deferred foreign earnings

States vary considerably in their taxation of foreign-source income earned by resident corporations and individuals (including by individuals indirectly through pass-through entities).

Some states may include in taxable income the automatic inclusion of a U.S. corporation's deferred foreign income under amended Internal Revenue Code Section 965. Under the federal tax reform, at the end of 2017 there was an automatic 15.5 percent tax applied on deferred foreign liquid assets like cash and an eight percent rate for other profits. This federal tax is payable over eight years, and is owed whether or not the cash or other assets were repatriated. Some states will tax this new federal income at the regular corporate income tax rate entirely in one year by requiring corporations to add-back the transition inclusion deduction.

For consolidated groups at the federal level, in determining the amount of previously deferred foreign earnings, netting is allowed among subsidiaries with positive earnings and profits (E&P) and negative E&P. It is not clear whether netting will be permitted by states. Finally, there are statutory and constitutional arguments that the previously deferred foreign earnings should not be taxed by states at all.

Net operating losses (NOLs)

The 2017 federal tax law reduces the usefulness of NOLs by generally prohibiting carry-backs and imposing a cap on the ability to use NOLs in carry-forward situations. While states are largely already decoupled from federal corporate NOL provisions, some states may also try to mirror the federal changes and impose an 80 percent limitation on NOLs or to prohibit state NOL carry-backs. Mismatches between federal consolidated corporate groups and state combined or consolidated corporate groups could also negatively impact the ability to utilize state NOLs.

Global intangible low taxed income (GILTI)

GILTI is a new form of foreign income that "leaks through" to a U.S. corporate parent for corporate income tax purposes. Foreign tax credits may offset much of the GILTI paid by certain corporations at the federal level. At the state corporate income tax level, however, foreign tax credits generally are not available, causing a potential increase in state tax liability due to the GILTI even if there is no significant federal income tax. Despite its similarities with Subpart F income, because GILTI is technically not a category of Subpart F income, states could decide to include GILTI in state taxable income even if they generally provide a deduction for Subpart F income. State dividend-received deductions do not protect against GILTI because GILTI is included in income regardless of whether any dividend is actually paid.

Foreign derived intangible income (FDII)

Finally, under the 2017 federal tax law, FDII is a new class of U.S.-sourced corporate income from foreign transactions. It is taxed at federal tax rates lower than the typical 21 percent federal corporate income tax rate due to special deductions. Some states may decide to deny the deduction through an add-back. Some states, including Illinois, have already introduced legislation to do this.

Please contact Mark Snider, Dave Tumen or any member of the Porter Wright Tax Practice Group with any questions.