State Responses to the Tax Cuts and Jobs Act: An Analysis from Indiana and Missouri

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INTRODUCTION

On December 22, 2017, President Trump signed into law P.L. 115-97, popularly known as the Tax Cuts and Jobs Act ("TCJA"), contained sweeping changes to federal tax law, and has been compared in breadth to the Tax Reform Act of 1986. Although the federal legislation is complete, various aspects of the TCJA's impact on state taxation are unclear. This Article, authored by lawyers from the Indiana Department of Revenue and Missouri Department of Revenue, is intended to address, and hopefully add clarity to, the complexities of state taxation under the TCJA.

After a brief historical and general overview of the TCJA, this Article focuses on seven distinct topics within the TCJA from a state perspective. These topics are: (1) Business Assets Expensing; (2) the TCJA's treatment of 529 Accounts; (3) the 30% Business Interest Limitation; (4) the Transition Tax (also referred to as "Deemed Repatriation"); (5) GILTI, or Global Intangible Low-Taxed Income; (6) the elimination of the Personal

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and Dependency Exemption Deductions; and (7) the Qualified Business Income Deduction. For each topic, this Article gives an overview of the associated TCJA provisions, addresses some responses of the states to these provisions, and provides opportunity for discussion of possible or actual responses by Indiana and/or Missouri.

I. THE HISTORY OF THE TCJA

The TCJA was the first fundamental rewrite of the federal income tax code since the Tax Reform Act of 1986. This continued a pattern of major tax laws being enacted every thirty to forty years: 1913; 1954; 1986; and 2017.

The first permanent income tax was imposed in 1913,[1] shortly after the ratification of the Sixteenth Amendment to the Constitution. The Amendment provided that: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."[2] Ratification of the Sixteenth Amendment was necessary for imposition of the income tax; the U.S. Supreme Court had ruled the income tax/capital gains portion of the Revenue Act of 1894 unconstitutional because it was a direct tax on individuals and therefore must be apportioned among the states according to population.[3]

The Revenue Act of 1913 imposed a progressive income tax with rates starting at one percent (1%) for high-income individuals and peaking at seven percent (7%) on individuals with very high incomes.[4] The significant increase in government expenditures to fight World War I resulted in a massive expansion of the income tax, both in rates and the taxpaying base. By 1918, the lowest rate was six percent (6%) with the

1. For the first several years of the tax, it was a year-to-year tax before being made permanent, but since its enactment in 1913, it has never expired.
2. U.S. CONST. amend. XVI.
3. Pollack v. Farmers' Loan & Tr. Co., 157 U.S. 429 (1895).
4. Revenue Act of 1913, Pub. L. No. 63-16 (1913).

highest rate being seventy-seven percent (77%).[5] Furthermore, individuals became subject to the income tax at a lower nominal income level and a much lower real income level.[6] The highest income tax rate peaked at ninety-four percent (94%) during World War II and was only lowered to ninety-one percent (91%) after the conclusion of the war.[7]

By 1954, it was apparent that there were many problems with the structure and equity of the income tax. The impact of the loopholes and distortions in the Code as written in 1913 were greatly magnified by the extremely high rates of taxation. Congress undertook a comprehensive rewrite of the Internal Revenue Code in the Internal Revenue Act of 1954.[8]

Over the next three decades, loopholes, tax preferences and tax expenditures proliferated to the point that a bipartisan consensus developed for the need for another comprehensive reform similar to the 1954 effort. In fact, although President Reagan championed the drive for tax reform and rate cuts, the legislative proposal was sponsored by Senator Bill Bradley and Representative Dick Gephardt, both Democrats. The Tax Reform Act of 1986 slashed income tax rates; broadened the tax base by eliminating numerous credits, deductions, and exclusions; and indexed tax brackets to inflation to prevent bracket creep. The extensive inflation during the 1960's and 1970's had resulted in passive tax increases by pushing taxpayers into higher tax brackets without an increase in real income or movement to a higher income percentile.

In the more than three decades since the passage of the 1986 reform, preferences, carve-outs and assorted provisions have cluttered the IRC. In response to the increased clutter, efforts to pass another comprehensive tax law began to build steam.

The two most recent comprehensive tax proposals prior to 2017 were

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5. *See U.S. Federal Individual Income Tax Rates History, 1862-2013, (Nominal and Inflation-Adjusted Brackets)*, TAX FOUND. (Oct. 17, 2013), https://taxfoundation.org/us-federal-individual-income-tax-rates-history-1913-2013-nominal-and-inflation-adjusted-brackets/.
6. *Id.*
7. *See id.*
8. Internal Revenue Act of 1954, Pub. L. 83-591, 68A Stat. 1 (1954).

the tax reform plan introduced by former Chairman of the House Ways and Means Committee Dave Camp in 2014,[9] and the "A Better Way" plan produced in 2016 by the then-Chairman of the House Ways and Means Committee Kevin Brady and supported by Speaker of the House of Representatives Paul Ryan.[10]

Neither plan served as a framework for the 2017 TCJA discussions due to a failure to build broad support and because the Brady/Ryan plan was a dramatic departure from current federal tax policy.[11] However, many of the minor provisions, especially the smaller revenue raisers, were cherry-picked by the TCJA bill drafters partly because they had already been developed and scored for their revenue impact by the Congressional Budget Office.

Unlike the tax reform law of 1954 and 1986, the TCJA was a highly partisan effort, passed with overwhelming Republican support and minimal votes from Democrats.[12] Another difference from the two earlier tax reform laws was that the 2017 law was scored as costing $1.5 trillion over the ten-year budget window, whereas the 1954 and 1986 were – or were intended to be – revenue neutral. [13]

II. THE TCJA: TAX CUTS AND JOB ACT

The TCJA contained extensive changes to the taxation of individuals,

9. H.R. 1, 113th Cong. (2014).
10. Tax Cuts & Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).
11. *See* Reuven S. Avi-Yonah, *Back to 1913? The Brady-Ryan Plan and Its Problems*, 131 TAX NOTES 1367 (2016) (noting the major changes in corporate taxes from the Brady-Ryan Plan).
12. *Compare* David E. Rosenbaum, *Senate 74-23, Votes Tax Bill; Widest Revisions in 40 Years Cuts Rates, Curb Deductions*, N.Y. TIMES, Sept. 28, 2016, at A1 (noting 33 Democratic senate votes) *with* Thomas Kaplan & Alan Rappeport, *Republican Tax Bill Passes Senate in 51-48 Vote*, N.Y. TIMES, Dec. 19, 2017, at A15 (noting no Democratic support).
13. *Compare* David E. Rosenbaum, *Senate 74-23, Votes Tax Bill; Widest Revisions in 40 Years Cuts Rates, Curb Deductions*, N.Y. TIMES, Sept. 28, 2016, at A1 (noting the bill was expected to net out between corporate and individual taxes) *with* Thomas Kaplan & Alan Rappeport, *Republican Tax Bill Passes Senate in 51-48 Vote*, N.Y. TIMES, Dec. 19, 2017, at A15 (noting $1.5 trillion projected deficit).

small businesses and C corporations. Some of the most complex and contentious provisions of the Act are those related to the international income of American businesses.

A. Individuals

The TCJA made significant changes to the taxation of individuals. The most impactful of these changes was the almost doubling of the standard deduction combined with the elimination of personal exemptions. In place of the personal exemptions for dependents, the TCJA expanded the child tax credit to $2,000 per qualifying dependent, with $1,400 of the credit being refundable.[14] In addition, the TCJA capped the deduction for state and local taxes ("SALT") paid to $10,000 and provided that interest would only be deductible on mortgages of up to $750,000 instead of the previous limit of $1,000,000. These changes mean that an estimated 61% fewer individuals will itemize in 2018 than did so in 2017.[15]

The TCJA maintained the seven rate brackets contained in the previous law, but lowered the applicable tax rate for five of the seven tax brackets. The rate applied to the top tax bracket was lowered from 39.6 percent to 37 percent. The thresholds for many of the brackets were also raised. This means that the vast majority of individuals will pay a lower rate on their federal adjusted gross income ("AGI"), though the interplay between the standard deduction, the SALT deduction, and the mortgage interest limitation may cause some taxpayers to have a higher federal AGI under the TCJA than they would have had under the previous tax regime.[16]

The tax law also doubled the gift and estate tax exemption and the

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14. I.R.C. § 24(h) (2018).
15. Politico Pro, Data Point on Taxes, August 10, 2018 (citing Tax Foundation as source).
16. FRANK SAMMARTINO, PHILLIP STALLWORTH & DAVID WEINER, THE EFFECT OF THE TCJA INDIVIDUAL INCOME TAX PROVISIONS ACROSS INCOME GROUPS AND ACROSS THE STATES, (2018), http
s://www.taxpolicycenter.org/sites/default/files/publication/154006/the_effect_of_the_tcja_individual_income_tax_provisions_across_income_groups_and_across_the_states.pdf (noting 6% of households will see a tax increase from the TCJA).

generation-skipping tax exemption.

B. Small Businesses

Most small businesses will benefit from the individual income tax rate reductions as they are organized as sole proprietorships or other pass-through entities.[17] Furthermore, the TCJA provides a 20% deduction for "qualified business income" for sole proprietorships, partnerships, limited liability companies and S-corporations.[18] The rules defining qualified business income are complex and limit the ability of certain service businesses – such as law firms and accounting firms – to claim the deduction.

The TCJA also incentivizes capital investment by small business through expanded bonus depreciation under IRC Sections 168 and 179. Section 168 bonus depreciation is increased to 100%, providing full expensing, for years 2018-2023. Furthermore, the provision now applies to used property. The TCJA expands the expensing cap for Section 179 from $500,000 to $1,000,000.

The TCJA also permits a much larger number of small businesses to use the cash method of accounting instead of the accrual method. This greatly simplifies accounting for these businesses and also provides cash flow benefits.

C. Corporations

The most important factor driving the push for federal tax reform was

17. *Cf.* Hannah Grabenstein, "Will small businesses benefit from the new tax law?" PBS (Feb. 27, 2018), https://www.pbs.org/newshour/economy/making-sense/will-small-businesses-benefit-from-the-new-tax-law.
18. *See generally* I.R.C. § 199A (2018).

the need to make the U.S. corporate tax system more competitive with other countries. Entering 2017, the U.S. statutory rate was the highest among OECD nations, though the effective rate varied greatly among businesses based on which tax preferences they were able to utilize.[19] President Trump promoted a 15% corporate tax rate. (The Camp plan would have lowered the corporate rate to 25%. A Better Way envisioned a 20% rate. As evidence of the strong support across the political spectrum for lowering the corporate tax rate, President Obama had floated the idea of lowering the rate to 28% as part of a broader tax plan.)

Another major challenge faced by American companies competing internationally was that the U.S. tax system taxed U.S.-based companies on their world-wide income, although a credit was given for foreign taxes paid. Most of the other developed countries impose corporate tax based on where the income is earned, using a territorial system. The mechanics of worldwide taxation, which only imposed U.S. tax on certain categories of overseas income when the earnings were repatriated to the U.S., resulted in American companies stashing large sums in overseas affiliates. The result was each company's payment of the tax was generally deferred until the profits were repatriated. In the years leading up to passage of the TCJA, American companies increasingly merged with smaller foreign companies and shifted the newly formed company's domicile to a foreign country. These "inversions" had become a major concern among policy makers. The TCJA addressed both of these concerns by significantly lowerig the statutory corporate income tax rate to 21% and converting the U.S. to a territorial tax system. In order to broaden the tax base, partially offset the revenue loss from these two changes, and guard against income shifting U.S. revenues to foreign affiliates, the TCJA contained several controversial provisions. The TCJA deemed a certain amount of foreign

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19. *Table II.1. Statutory Corporate Income Tax Rate (2016 & 2017)*, ORG. FOR ECON. CO-OPERATION & DEV. (Oct. 7, 2018 10:37 AM), https://stats.oecd.org/index.aspx?DataSetCode=Table_II1 (reflecting France's new rate since it raised its corporate tax rate during 2017).

retained earnings of American companies to be repatriated at one of two reduced tax rates, depending on the form in which the earnings were held.[20] Moreover, new provisions were created to protect the American tax base against income shifting. The most substantial of these was the Global Intangible Low-Taxed Income (GILTI).[21] These provisions will be explored further in this Article.

Several other provisions were enacted to limit the extent to which companies are able to offset income through the use of net operating losses and interest expenses. The TCJA limited a company's use of net operating losses (NOL) to 80% of adjusted taxable income, eliminated carrybacks of net operating losses, and prevented using deductions used to compute lower tax rates as part of the net operating loss computation.[22] It did, however, extend the carryforward period for NOLs from twenty years to an indefinite period.[23] The law also limits the use of net business interest expense to 30% of adjusted taxable income plus certain financing such as floor planning.[24] The interest expense limitation provision will be explored further in this Article.

III. STATE RESPONSES TO THE TCJA

A. The Analytical Structure

The discussion below focuses on the relationship of the states, especially Missouri and Indiana, to seven selected provisions from within the TCJA. For each provision, an overview of the TCJA's language and operations, as well as certain federal developments on the issue are presented. Then, state reactions are evaluated following, roughly, the categories further described below. Next, certain real or possible responses

20. *See* I.R.C. § 965 (2018).
21. *See* I.R.C. § 951A (2018).
22. This statement does not apply to the deduction under I.R.C. § 965(c). I.R.C. § 172 (2018).
23. I.R.C. § 172(e) (2018).
24. I.R.C. § 163(j) (2018).

by Indiana or Missouri are explained. Finally, the potential impact on or behavioral changes of taxpayers is explored. A conclusion is provided at the end of this Article.

B. Categories of State Conformity to the Internal Revenue Code

States can be categorized according to how their systems of income taxation relate to the Internal Revenue Code (IRC). Many states automatically base their system of income taxation off of the most current version of the IRC, referred to as "rolling conformity."[25] Another large group of states conform their system of income taxation to the IRC as of a particular date, which must be updated by their legislatures in order to conform to a later-enacted version of the IRC.[26] This is referred to as "fixed conformity."[27] A third, smaller, group of states selects only certain provisions of the IRC with which to conform.[28] This is referred to as "selective conformity."[29] Finally, a number of states either have no income tax, or impose a gross receipts tax in lieu of an income tax. This last group of states is not addressed in this Article.

States may be included in one of the above categories because they more or less meet the category's description, but a state may deviate from its category in some particulars. For example, although Missouri is fairly categorized as a rolling conformity state, it effectively decouples from the IRC in some ways, such as by adding back non-Missouri state and local bond interest into its corporate and individual income tax base.[30] The below map[31] illustrates the different conformity types used by the various

25. *See* Jeffrey A. Friedman et al., *Insight: Waiting for the Other Shoe to Drop: State and Local Tax Implications of Federal Tax Reform – International Provisions*, BNA DAILY TAX REPORT (March 9, 2018), https://www.bna.com/insight-waiting-shoe-n57982089695/.
26. *Cf. id.*
27. *Cf. id.*
28. *See id.*
29. *See id.*
30. *See* MO. REV. STAT § 143.121.2(2) (2016); MO. REV. STAT. § 143.431.2 (2018).
31. Map editing by Shelby Finch of the Missouri Department of Revenue. Determination of state

states in the context of state corporate income taxes:

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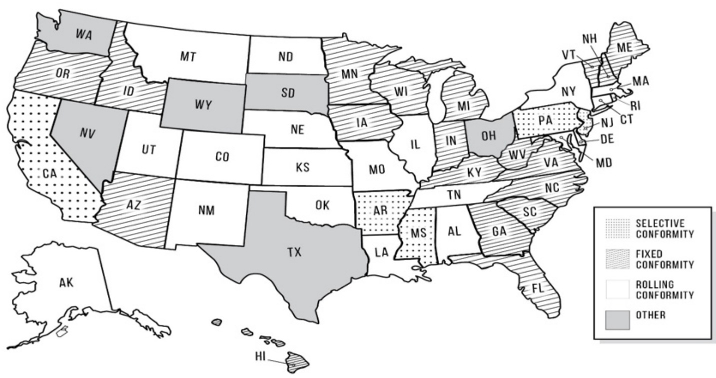
conformity for map based on the following: Andrew Phillips & Steve Wlodychak, *The Impact of Federal Tax Reform on State Corporate Income Taxes*, ERNST & YOUNG (Mar. 2018) [hereinafter Phillips & Wlodychak], https://www.ey.com/Publication/vwLUAssets/ey-the-impact-of-federal-tax-reform-on-sta
te-corporate-income-taxes/$File/ey-the-impact-of-federal-tax-reform-on-state-corporate-incometaxes.p df; Jeffrey A. Friedman et al., *Insight: Waiting for the Other Shoe to Drop: State and Local Tax Implications of Federal Tax Reform – International Tax Provisions*, BLOOMBERG (Mar. 9, 2018), https://
www.bna.com/insight-waiting-shoe-n57982089695/; Jared Walczak, "Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform," Tax Foundation (Jan. 31, 2018), https://taxfoundation.org/state-conformity-federal-tax-reform/; *Commercial Activity Tax (CAT): Table of Contents*, Ohio Department of Taxation (last visited Jan. 2019), https://www.tax.ohi
o.gov/commercial_activities.aspx; ORS § 317.010(7); ORS § 318.031; Oregon Department of Revenue Research Section, *Oregon Corporate Excise and Income Tax: 2016 Edition* (Salem, OR 2016), https://www.oregon.gov/DOR/programs/gov-research/Documents/corporate-excise-income_102-405_
2016.pdf; MCL § 206.607(6); *Franchise Tax Overview*, 98-806, Texas Comptroller's Office (Jan. 2016), https://comptroller.texas.gov/taxes/publications/98-806.php; Arkansas Act 155 (2017), http://www.arkl
eg.state.ar.us/assembly/2017/2017R/Acts/Act155.pdf; Robert Steiger, *IRC Conformity: A California Tax Practice Insights Commentary*, LexisNexis Tax Center (Jun. 7, 2011), https://www.lexisnexis.com/l
egalnewsroom/tax-law/b/taxguidanceessentials/posts/irc-conformity-a-california-tax-practice-insight-c ommentary; *California Conformity to Federal Law*, State of California Franchise Tax Board (Last Updated Aug. 2, 2018), https://www.ftb.ca.gov/forms/updates/conformity.shtml; PA REV-1200 Booklet, Pennsylvania Department of Revenue (Dec. 2017), https://www.revenue.pa.gov/FormsandPubl
ications/FormsforBusinesses/CorporationTax/Documents/2017/2017_rev1200.pdf. Public domain base map from https://commons.wikimedia.org/wiki/File:Blank_US_map_borders_labels.svg (based on map from U.S. Central Intelligence Agency, *available at* https://legacy.lib.utexas.edu/maps/united_states/usa
_ref01.pdf).



IV. BUSINESS ASSET EXPENSING

A. Business Assets Expensing Before the TCJA

Under the pre-TCJA Internal Revenue Code, there were several provisions that permitted either total expensing or allowed for "bonus depreciation" for purchases of tangible personal property and improvements to realty (or property incorporated into realty). The most notable of these was IRC § 168(k), which provided for up-front fifty percent (50%) depreciation for certain property placed into service before 2020.[32] In addition, the original use of the property had to be by the taxpayer claiming the depreciation; in other words, used property was not eligible even if it was the taxpayer's first use.

In addition, IRC § 179 provided for additional expensing for tangible personal property, computer software, and certain real property. A taxpayer was also permitted an election to include qualified leasehold improvement property, qualified restaurant property, and qualified retail

32. There was a phase-down for 2018 and 2019. *See* I.R.C. § 168(k)(6) (2018). IRC § 168(k) had been subject to many extensions prior to TCJA. I.R.C. § 168(k) (2018).

improvement property as Section 179 property.[33] Prior to the TCJA, the amount of expensing permitted as a deduction was $500,000. In addition, if more than $2,000,000 in section 179 property was placed in service during a taxable year, the $500,000 limitation was reduced on a dollar-by-dollar basis.[34] These amounts were subject to inflation adjustments based on the unchained consumer price index. The deductible amount was further limited by the taxable income from the trade or business, both at the entity level and at the owner level;[35] however, any disallowed expensing deduction (i.e. a deduction subject to a limitation under IRC § 179(b)) was permitted as a carryover to future taxable years.[36]

B. Changes Enacted By the TCJA

The TCJA made two important modifications to depreciation. For § 168(k) bonus depreciation, property for which expensing is allowed expanded to include certain qualified productions and to include used property, provided that it was the taxpayer's first use of the property.[37] However, bonus depreciation is no longer allowable for qualified improvement property.[38]

The amount allowable as first-year depreciation was increased to 100% for property placed into service after September 27, 2017, and before January 1, 2023.[39] Starting in 2023, the amount of allowable first-year depreciation decreases by 20% each year until property placed into service

33. IRC § 179(d)(1) (2012 & Supp. V 2017).
34. For qualified disaster assistance property, the $500,000 limit and $2,000,000 phase-out threshold were increased to $600,000 and $2,600,000 respectively. *See* I.R.C. § 179(e) (2012 & Supp. V 2017).
35. I.R.C. § 179(d)(8) (2012 & Supp. V 2017).
36. I.R.C. § 179(b)(3) (2012 & Supp. V 2017); *see also* I.R.C. § 168(d)(8) (2012 & Supp. V 2017) (treating partnership and S corporation limitations).
37. Tax Cuts & Jobs Act, Pub. L. No. 115-97 (2017); *see* I.R.C. § 168(k)(2).
38. I.R.C. § 168(k)(3) (2017) (2012 & Supp. V 2017).
39. Certain aircraft and property with longer depreciation periods will be permitted an additional year of 100% expensing, with other relevant periods also extended an additional year. I.R.C. § 168(k)(6)(B) (2012 & Supp. V 2017).

2027 is entitled to zero bonus depreciation. For property purchased before September 28, 2017, and placed into service after September 27, 2017, the percentages allowable as bonus depreciation are reduced based on the year the property is placed into service.[40] In addition, the amount of depreciation allowable for luxury automobiles was increased.[41] Further, IRC § 168(k)(9) provides that certain property not subject to the interest limitations under IRC § 163(j) is not eligible for bonus depreciation.

For IRC § 179 expensing, the amount of allowable expensing was increased to $1,000,000, and the phase-out limit was increased to $2,500,000.[42] In addition, inflation adjustments are based on chained CPI-U as opposed to unchained CPI-U.[43] Further, at the taxpayer's election, qualified improvement property as well as roofs, HVAC property, fire protection and alarm systems, and security systems can be treated as Section 179 property.[44]

Much of the reason for expensing is to encourage purchasing equipment by giving the up-front benefit of the deduction rather than having to wait over an extended period of time. The enhanced expensing is designed to encourage that even more.

V. STATE RESPONSES TO THIS TCJA PROVISION

In general, most states have chosen to continue following the text of

40. I.R.C. § 168(k)(8) (2012 & Supp. V 2017).
41. I.R.C. § 168(k)(2)(F) (2012 & Supp. V 2017).
42. The additional allowances under I.R.C. § 179(e) are also allowable. I.R.C. § 179(e) (2012 & Supp. V 2017).
43. CPI-U is the consumer price index based on a fixed basket of goods. Chained CPI-U takes into account substitution effects between goods. For instance, regular CPI-U assumes that a customer will buy X amount of tomatoes and Y amount of carrots regardless of price. Chained CPI-U accounts for situations where, if the price of tomatoes increases, individuals may purchase more carrots. *See, generally Chained CPI*, BUREAU OF LABOR STATISTICS, https://www.bls.gov/cpi/additional-resources/c
hained-cpi-questions-and-answers.htm (last visited Dec. 5, 2018).
44. I.R.C. § 179(f) (2018).

their pre-TCJA statutes. If a state had conformed to IRC § 168(k) and/or IRC § 179, the state will pick up the federal changes, increasing the state-specific deduction in the first year.

A. States with Specific Disallowances

Some states tied their calculation of depreciation to the Internal Revenue Code as in effect on a certain date, fully disallowed bonus depreciation, and/or determined expensing amounts under IRC § 179 based on fixed amounts. For these states, federal tax reform had no substantive effect on depreciation. However, it may have had an effect on the magnitude of a taxpayer's adjustments. Further, to the extent that the TCJA affected the definitions of qualifying property, these states have explicitly decoupled.

B. Fixed Conformity States

For a fixed conformity state, if the state fully coupled with IRC § 168(k) and/or §179, the effect would depend on when the conformity date would be after TCJA. For instance, if a state enacted legislation to make the conformity date on or after the date on which TCJA went into effect (generally January 1, 2018), the state would pick up the changes.

On the other hand, if a state, by deliberate legislative choice (e.g., Arizona)[45] or for other reasons (e.g., Minnesota), did not update its IRC conformity date, this represents a partial decoupling. For IRC § 168(k) bonus depreciation, this would represent two sets of modifications. First, the portion for newly defined property (e.g., used property) would be entirely disallowed. Second, for any remaining property subject to the bonus depreciation allowance, one-half of the bonus depreciation would be disallowed, with depreciation computed otherwise in accordance with state laws.

45. ARIZ. REV. STAT. ANN. § 43-105(B) (2017); ARIZ. REV. STAT. ANN. § 43-1022(19)(E) (2017).

For IRC § 179 property, if a state did not adopt a revised Internal Revenue Code conformity date, this would also mean two modifications. First, the expensing allowances would be required to be computed without regard to newly-included property. This could affect both the limitation and the phase-out thresholds. Generally, this would serve to reduce the allowance, but could increase the allowance in rare cases (e.g., a substantial purchase of property that qualifies post-TCJA but not pre-TCJA). Second, the pre-TCJA expensing computations ($510,000 in property and $2,030,000 general phase-out) would also apply, which would lead to a reduction for many taxpayers.

For some states (*e.g.*, Florida and Ohio), state law provides for a partial first-year disallowance, followed by a percentage allowance. This may be stated as adding back 80% of bonus depreciation in the first year, followed by subtracting 20% in each of the next four years. For these states, there is an increase in the first-year allowance, though not to the full extent of the federal increase. For assets subject to bonus depreciation, the effect is to make the useful life equal to the extended period. Before TCJA, the state law would have required the non-bonus portion of the depreciation to be computed over the normal useful life of the asset and the bonus portion over the state-specific allowance period.

As of the date this section was principally written, with the exception of Iowa, Pennsylvania, and Connecticut, discussed below, no state actually changed its depreciation statutes or positions.

C. Rolling Conformity States

For rolling conformity states, the TCJA's effect mirrors what would happen if the state simply updated its IRC definition to January 1, 2018, or later.

D. Unique State Reactions

Though most states did not change their depreciation statutes in light of

TCJA, one notable exception to inaction is Connecticut. Connecticut previously allowed full § 179 expensing. Connecticut reacted to TCJA by disallowing eighty percent of the first-year § 179.

A second unique response was Iowa, which had previously completely decoupled from IRC § 179. Iowa enacted a two-year partial expansion of § 179 expensing. In particular, Iowa allows $70,000 in bonus depreciation for 2018 and $100,000 for 2019, with a phase-out threshold of $280,000 for 2018 and $400,000 for 2019. This is in contrast to Iowa's previous $25,000 deduction limit and $200,000 phase-out threshold.

A third response, albeit indirect, was from Pennsylvania. From 2011 to 2017, Pennsylvania recognized federal bonus depreciation. However, in late 2017, Pennsylvania issued guidance to the effect that not only did Pennsylvania not recognize bonus depreciation for property placed into service after September 27, 2017 (i.e., property eligible for full expensing), but Pennsylvania also did not recognize any other adjustment to depreciation as well until the year of disposal. In 2018, Pennsylvania passed legislation that decoupled from bonus depreciation but allowed the otherwise regular depreciation in accordance with IRC § 168.[46]

E. Missouri Responses

Missouri is a rolling conformity state under Section 143.091, RSMo. While Missouri is capable of decoupling from the IRC as to this provision, Missouri has not decoupled from either IRC Section 168(k) or Section 179 in response to the TCJA.[47] Thus, by doing nothing, Missouri has passively coupled to the changes in depreciation for tax purposes accomplished by the TCJA.

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46. Tax Reform Code of 1971, Defining Taxable Income, Pub. L. No. 494-72 (Pa. 2018).

47. In very limited circumstances, certain property may be subject to a depreciation basis adjustment in Missouri. *See* MO. REV. STAT. § 143.121.2(3) (2016); Form MO-1120 (2017).

F. Indiana Responses

To explain Indiana's response, some background is necessary. In 2003, Indiana decoupled from bonus depreciation under IRC § 168(k). Indiana's law otherwise effectively coupled with the federal depreciation system except for bonus depreciation.[48]

In addition, Indiana decoupled from enhanced expensing under IRC § 179. However, Indiana only decoupled from the amount allowable as expensing, limiting the amount to $25,000. Indiana's statute did not decouple from the increased federal phase-out or from any additional property categories eligible from expensing.

With the TCJA, Indiana did not make any underlying changes to its statutes. For bonus depreciation under IRC § 168(k), this means that Indiana will continue to allow the same amount of depreciation after modification. However, the amount of the modifications from year to year will change.[49]

Likewise, for IRC § 179 depreciation, Indiana picks up the revised categories of section 179 property and the $2,500,000 phase-out threshold. However, the amount of expensing deduction is still limited to $25,000 as opposed to $1,000,000.

G. Predictions of Taxpayer Responses

In order to take advantage of the immediate tax benefit, taxpayers are expected to respond to this TCJA provision by increasing purchases of capital equipment. It is likely that the response of taxpayers will result

48. There have been historical instances where Indiana decoupled from industry-specific expensing; however, those have been repealed.

49. Using a simplified example, assume $1,000,000 of eligible property with a five-year depreciation period is purchased on May 1. Before TCJA, the property would have had $500,000 of bonus depreciation and $62,500 in regular depreciation in year 1, whereas Indiana would only recognize $125,000, generating a $437,500 add-back in year 1 and resulting offsets in later years. After TCJA, the full $1,000,000 would be subject to immediate expensing, but Indiana would still have $125,000 in depreciation, resulting in an $875,000 add-back.

from the TCJA's changes to federal law, as opposed to changes in the laws of specific states.

VI. 529 ACCOUNTS

A. Federal 529 Plan Law before the TCJA

Prior to the TCJA, IRC Section 529 allowed a person to make cash contributions to an account on behalf of a beneficiary for payment of qualified higher education expenses. The account must have been part of a program established and maintained by a state or a state agency. Qualified higher education expenses included tuition, fees, books, supplies, and equipment required by the educational institution for enrollment or attendance. Reasonable room and board expenses were included if the beneficiary was enrolled at least half-time.[50]

A contribution to an account was considered a gift of a present interest for federal gift tax purposes and thus was eligible for the $15,000 annual exclusion,[51] but the contribution was not considered payment of education expenses subject to an unlimited exclusion. In addition, if a donor made a contribution of greater than $15,000, the donor could have elected to treat the contribution as being made equally over five years.[52] Amounts contributed in a 529 account generally were not subject to federal estate tax.[53]

While funds were in the 529 account, any earnings on the account were not subject to income tax, either at the donor level or at the account level. When funds were withdrawn from the account, the withdrawal was

50. I.R.C. § 529 (2018).
51. I.R.C. § 529(c)(2) (2018).
52. I.R.C. § 529(c)(2)(B) (2018).
53. The one notable exception is when a donor (1) makes an excess donation for which an election to treat the contribution as being made ratably over five years and (2) passes away prior to the end of the five-year period. In that case, the portion that has not been subject to a gift tax exclusion is included in the donor's gross estate.

prorated between the principal of the account (i.e., the contributions) and earnings in the account.

If a withdrawal was made for qualified higher education expenses, the withdrawal was not subject to income tax. In addition, rollovers from one 529 account to another, either for that beneficiary or to an account for a family member of the beneficiary, were generally exempt from income tax. If a withdrawal was made for reasons other than payment of qualified higher education expenses, the portion of the withdrawal attributable to earnings in the account was subject to income tax for the distributee. In addition, the withdrawal was also subject to a ten percent surtax in many circumstances.[54]

B. TCJA Modification of Federal 529 Plan Law and Policy Rationale

Late in the legislative process of passing the TCJA, Senator Ted Cruz (R-TX) inserted a proposal to expand the federal definition of "qualified education expenses" to include expenses related to tuition for kindergarten through high school (K-12). There were several policy reasons for supporting this expansion of qualified educated expenses. First, elementary and secondary school expenses are a considerable financial burden on parents of children in private and parochial schools. Allowing parents and others to utilize a 529 Education Savings Plan to plan for these expenses partially mitigates this burden. Second, including K-12 tuition expenses as qualified education expenses would presumably significantly expand the use of these programs. This would increase the impact of the TCJA on individuals and affect the projected distributional impact of the overall TCJA between individuals and businesses and among individual income quintiles.

In addition, rollovers from 529 Education Savings Plans to ABLE

54. I.R.C. § 529(c)(6) (2018). This also incorporates the exceptions found in IRC § 530(d)(4)(B). I.R.C. § 530(d)(4)(B) (2018).

accounts are not subject to income tax.[55] However, the ABLE account must be for the beneficiary or a family member of a beneficiary. In addition, the amount permitted to be rolled over for a beneficiary in a year may not exceed the federal gift tax exclusion amount minus all other contributions to the ABLE account during the taxable year.

VII. STATE RESPONSES TO TCJA MODIFICATION OF FEDERAL 529 PLAN LAW

States are still in the process of making their legislative responses to the TCJA, but as of this writing, some states have expanded their definition of "qualified education expense" to encompass at least some K-12 expenses. The impact on the 529 plans for certain states is as follows.

A. Rolling Conformity States

Alabama. The Alabama Department of Revenue reports that its 529 plan accounts are tied to the federal legislation.[56] It further states that, "[e]ffective for withdrawals after 12/31/2017, the [TCJA] expanded the definition of qualified higher education expenses to allow up to $10,000 per year of 529 plan account funds to be used for elementary or secondary school tuition."[57] Alabama also conforms to the TCJA provision pertaining

55. I.R.C. § 529(c)(3)(C)(i)) (2018).
56. ALA. DEP'T OF REVENUE, ANALYSIS OF FEDERAL TAX LAW REVISIONS ON ALABAMA (2018) [hereinafter ANALYSIS OF FED. TAX LAW REVISIONS ON AL.], https://revenue.alabama.gov/wp-content/uploads/2018/07/180730_TCJAeffectsAlabama.pdf.
57. ALA. DEP'T OF REVENUE, ALABAMA 529 SAVINGS PLAN FAQ, (2018), https://revenue.alabama.g
ov/individual-corporate/alabama-529-savings-plan- faq/.

to the rollover of 529 plan accounts into ABLE accounts.[58]

Connecticut. Under Connecticut's state-sponsored 529 Program, CHET, a distribution for elementary or high school expenses is not considered a qualified withdrawal.[59] Similarly, the rollover of an amount attributable to earnings in a 529 plan to an ABLE account will be taxable under Connecticut's income tax.[60]

Montana. The Montana Department of Revenue states that: "[d]espite changes made to IRC 529 in the 'Tax Cuts and Jobs Act', a withdrawal from a Montana 529 Plan to pay for K-12 tuition continues to be a nonqualified withdrawal under the Montana Family Education Savings Act."[61]

B. Fixed Conformity States

Kentucky. On April 10, 2018, the governor of Kentucky signed legislation changing Kentucky's definitions of "qualified educational expenses" and "educational institution" in order to follow the TCJA's changes to IRC § 529.[62] Kentucky's definitions of those terms now permit 529 plan expenditures on K-12 education.[63]

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58. ANALYSIS OF FED. TAX LAW REVISIONS ON ALA., *supra* note 56; Bruce P. Ely et al., *Summary of Newly Released ADOR Analysis of Federal Tax Reform's Impact on Alabama Income Tax Laws*, BRADLEY ARANT BOULT CUMMINGS LLP (Aug. 13, 2018), https://www.bradley.com/insights/publiccat ions/2018/08/summary-of-newly-released-ador-analysis-of-federal-tax-reforms-impact-on-alabama-in come-tax-laws.

59. *See Important News: Federal Legislation Includes Changes to Section 529 College Savings Plan*, CHET: 529 C. SAV. PROGRAM (Oct. 1, 2018), https://www.aboutchet.com/buzz/?cat=1.

60. *See id.* Further, in response to the TCJA, Connecticut passed Connecticut Public Act No. 18-49. *See* DELOITTE, CONNECTICUT ENACTS NEW PASS-THROUGH ENTITY TAX AND OTHER TAX LAW CHANGES (2018), https:// www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-connecti cut-enacts-new-pass-through-entity-tax-and-other-tax-law-changes.pdf.

61. MONT. DEP'T OF REVENUE, WITHDRAWALS FROM MONTANA 529 PLANS TO PAY FOR K-12 MAY BE TAXABLE IN MONTANA (2018), https://mtrevenue.gov/2018/03/01/withdrawals-montana-529-plans-may-be-taxable/.

62. H.B. 434 § 1(6) REC., Reg. Sess. (Ky. 2018); H.B. 434 § 1(13) REC., Reg. Sess. (Ky. 2018).

63. *See generally* H.B. 434, 2018 Leg., Reg. Sess. (Ky. 2018); *see also* CCH Tax Grp., *Kentucky*

Hawaii. As of June 2018, Hawaii has decoupled from the federal provision expanding "qualified higher education expenses" to K-12 tuition expenses.[64] Hawaii does allow rollover to an ABLE plan. Hawaii previously decoupled from the additional tax on distributions from ABLE account that are not used for disability expenses. [65]

Iowa. Iowa has updated its conformity to the TCJA; this expands the use of money in 529 accounts to "up to $10,000 per beneficiary, per year for tuition expenses for attending an accredited elementary or secondary (K-12) school in Iowa."[66] Although certain restrictions apply, Iowa now also allows 529 Accounts to be rolled into Iowa ABLE accounts without triggering an increase in Iowa taxes.[67]

North Carolina. Overcoming a veto by its governor, North Carolina enacted Session Law 2018-5 on June 12, 2018.[68] Session Law 2018-5 changed the addback of amounts withdrawn from a taxpayer's North Carolina Parental Savings Trust Fund account not used for "the qualified higher" education expenses to "amounts not used to pay for "expenses of the designated beneficiary as permitted under section 529 of the Code."[69] Session Law 2018-5 further expanded the program to allow contributions from "other interested parties" instead of just "qualified parents," and permitted the funds to be saved for expenses in accord with Section 529 of the IRC instead of only for postsecondary education.[70]

Expands 529 Education Rules, WOLTERS KLUWER (Apr. 12, 2018), http://news.cchgroup.com/2018/04/12/kentucky-expands-qualifying-529-education- institutions-and-expenses/.

64. HAW. DEP'T OF TAX'N, DEP'T OF TAX'N ANNOUNCEMENT NO. 2018-13 (Sept. 4, 2018), http://files.hawaii.gov/tax/news/announce/ann18-13.pdf; Hawaii Act 27.

65. *Id.*

66. IOWA DEP'T OF REVENUE, IOWA TAX REFORM GUIDANCE: C. SAV. IOWA (529 PLAN) DEDUCTION (2018).

67. *Id.*

68. *See* N.C. Act of July 1, 2018, 2018, N.C. Sess. Laws.

69. *See id.* (amending Section 116-209.25).

70. *Id.*

C. Selective Conformity States

Arkansas. Arkansas allows rollovers into ABLE accounts.[71] Beginning on January 1, 2018, Arkansas will also permit qualified withdrawals to be made for K-12 tuition expenses.[72]

California. California decoupled from the increased federal contribution limit to ABLE accounts. California also decoupled from the federal provision allowing the rollover of 529 accounts to an ABLE account without penalty. Further, California does not conform to the federal expansion of qualified education expenses to elementary and secondary education.[73] It also decoupled from the federal expansion of the maximum distribution amount.[74]

D. Indiana's Legislative Response to 529 Plan Changes

Indiana expanded the use of college choice 529 education savings plans to "qualified K-12 education expenses."[75] Indiana's legislation defines "qualified K-12 education expenses" as expenses that are permitted under Section 529 of the Internal Revenue Code and are for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school located in Indiana.[76]

Indiana provides a credit of the lesser of $1,000 or 20 percent of the contribution made by a taxpayer to an Indiana 529 plan. For 2018, Indiana limits the credit provided for contributions to be used for qualified K-12 expenses to the lesser of $500 or 10 percent of the contribution made by a taxpayer to an Indiana 529 plan. The global limit of $1,000 for the credit

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71. *See* ARK. 529, GIFT 529 FAQS (2018), https://www.arkansas529.org/home/faqs.html.
72. *See* ARK. CODE ANN. § 6-84-102 (West 2018); ARK. CODE ANN. § 6-84-103; ARK. 529 *supra* note 71.
73. CAL. FRANCHISE TAX BD., SUMMARY OF FEDERAL INCOME TAX CHANGES (2017), https://www.ftb.ca.gov/law/legis/Federal-Tax-Changes/2017-051618.pdf.
74. *Id.*
75. H.R. 1366(ss), 2018 Gen. Assemb., Spec. Sess. (Ind. 2018).
76. IND. CODE § 6-3-3-12 (2018).

for combined K-12 and college education contributions still applies. Further, if the credit is greater than the taxpayer's liability, the credit is limited to the taxpayer's liability, and any carryover or carryback is not permitted.

Beginning in 2019, the limit for the tax credit provided for K-12 contributions rises to the lesser of $1,000 or 20 percent of the contribution made by a taxpayer to an Indiana 529 plan. On making a contribution or withdrawal, the contributor is required to designate whether the contribution is made, or the withdrawal will be used, for: (1) qualified higher education expenses that are not qualified K-12 education expenses; or (2) qualified K-12 education expenses. The legislation directs the Indiana education savings authority to use sub-accounting to track the designations.[77] The global limit of $1,000 for the credit for combined K-12 and college educations contributions still applies.

E. Missouri's Response to 529 Plan Changes

In its 2018 legislative session, Missouri's General Assembly passed SB 882, which amended statutory language relating to Missouri's 529 savings plan: the Missouri Education Savings Program ("MOST").[78] SB 882 changes, among other things, the definition of educational institutions eligible for the tax benefits of MOST 529 accounts to expressly include "elementary and secondary education as provided in Sections 529(c)(7) and 529(e)(3) of the Internal Revenue Code, as amended[.]"[79] Following the TCJA, SB 882 also generally permits holders of MOST 529 accounts to transfer amounts from that account into an ABLE account without penalty, although certain restrictions apply.[80] Because SB 882 references

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77. IND. CODE § 21-9-3-5 (2018).
78. *See* S. 882, 2018 Gen. Assemb., Reg. Sess. (Mo. 2018); *cf.* MO. STATE TREASURER, MOST: MISSOURI'S 529 SAVINGS PLAN (last visited Oct. 10, 2018), https://www/missourimost.org.
79. S. 882, 2018 Gen. Assemb., Reg. Sess. (Mo. 2018); MO. REV. STAT. § 166.410(4) (2016).
80. *See, e.g.*, MO. ANN. STAT. § 166.435(2) (2018); Eric Schmitt, *Press Release,* (May 22, 2018), https://www.treasurer.mo.gov/newsroom/news-and-events/2018/05/22/treasurer-schmitt-highlights-leg

IRC sections that were themselves created or amended by the TCJA, it is appropriate to say that Missouri's SB 882 was passed at least partially in response to the TCJA.

F. Predictions of How Taxpayers Will Respond

As a general matter, states may see an increase in the use of 529 Plans following the passage of the TCJA, especially if, when applicable, states adopt legislation further advancing 529 Plans. Indiana expects that the expansion of the scope of Indiana's 529 plan and accompanying credit will lead to significantly increased utilization of the program. The unofficial rough estimate considered during Indiana's legislative process was that usage would increase by 55-70%.

VIII. THE 30% BUSINESS INTEREST LIMITATION

A. Business Interest Before the TCJA

Prior to the TCJA, IRC §163 provided a deduction for interest subject to certain limitations. For interest incurred in operating a trade or business, the interest was allowable unless some other limitation applied (see, e.g., IRC § 163(d), relating to investment interest, and IRC § 163(j), related to earnings stripping). This was largely a recognition that interest was a legitimate business expense.

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islative-accomplishments-for-2018-session.

B. The TCJA's Imposition of the 30% Business Interest Limitation

The TCJA rewrote IRC § 163(j) by placing a limitation on the deductibility of "business interest." "Business interest" is generally defined as interest incurred in the operation of a trade or business.[81] Investment interest is not considered "business interest" under this section; instead, investment interest is subject to its own stand-alone limitation.

In addition, "trade or business" is defined to not include services as an employee, the operation of certain utilities, and gas or steam pipeline transportation. Also, certain real property business and farming businesses can elect to not be treated as a "trade or business" for purposes of the interest limitation. For purposes of how much interest is allowable as a deduction, these items are only limited by other limitations in the Internal Revenue Code.

Also, any limitation under IRC § 163(j) does not apply to taxpayers with average annual gross receipts of $25,000,000 over the previous three-year period.

The TCJA adopted a "thin capitalization" approach: business interest is generally limited to the sum of business interest income, floor plan financing interest (generally, automobile financing), and thirty percent (30%) of the adjusted taxable income of the taxpayer. "Adjusted taxable income" equals the taxable income of the taxpayer adjusted to remove: (1) net income not properly allocated to a trade or business; (2) any business interest expense or business interest income; (3) any net operating loss deduction; (4) any deduction for qualified business income under IRC § 199A; and (5) for taxable years beginning before January 1, 2022, any depreciation, depletion, or amortization deductions.[82] If any interest is disallowed in the first year, the general rule is that disallowed interest is treated as business interest incurred the next year.

For purposes of determining the limitation for S corporations and

81. I.R.C. § 163(j)(5) (2018).
82. *See* I.R.C. § 168(j)(8) (2018).

partnerships, special rules apply.[83] The IRS has not issued regulations on the subject but has issued guidance on the subject.[84] Federal law generally requires computing the interest limitation in the first year at the partnership or S corporation level, with a resulting future subtraction based on "excess taxable income" derived from the partnership or S corporation.

Much of the interest limitation was driven by the enhanced depreciation allowances. For instance, companies with floor plan interest expenses and utility companies are specifically excluded from being able to take advantage of expensing under IRC § 168(k).[85]

IX. STATE REACTIONS TO THE 30% BUSINESS INTEREST LIMITATION

Few states have had any express reactions. For the most part, this has amounted to tacit compliance. However, there are exceptions, most notably for fixed conformity or stand-alone interest deductions.

For many states, a state may conform to the federal interest limitation but have a disallowance for related-company interest. In a case such as that, the state must address how that limitation will be computed.

A. Fixed Conformity States

For a fixed conformity state, if the conformity date of the Internal Revenue Code was not updated, or was updated to a date before January 1, 2018, the state would automatically decouple from IRC § 163(j), and instead compute interest deductions under the pre-TCJA § 163. This would have the effect of requiring a subtraction in the first year, followed by addbacks in years after the interest was first incurred.

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83. *See generally* I.R.C. § 163(j)(4) (2018).
84. *Initial Guidance under Section 163(j) as Applicable to Taxable Years Beginning After Dec. 31, 2017*, I.R.S. (last visited Sept. 6, 2018), https://www.irs.gov/pub/irs-drop/n-18-28.pdf.
85. I.R.C. § 168(k)(9) (2018).

If a state coupled to a date after December 31, 2017, the state would adopt the limitation unless the state either explicitly decoupled or had its own interest deduction. A handful of states (Georgia, Indiana, and Wisconsin) have explicitly decoupled from the federal limitation.

B. Rolling Conformity States

For a rolling conformity state, the state would automatically pick up the IRC § 163(j) limitation unless the state deliberately decoupled. Only two states have reacted so far along these lines. One state is Connecticut, which decoupled from the limitation for corporations but not for individuals. In addition, Tennessee will remain coupled to the IRC § 163(j) limitation until January 1, 2020. At that point, Tennessee will be decoupled from the interest limitations.

Alabama has also updated its guidance on related-company interest disallowance. In the case where both the IRC § 163(j) limitation and a related-company disallowance apply to the same payment, Alabama will prorate the related-company disallowance across the allowable interest under IRC § 163(j).

One unique reaction was Iowa's reaction. For 2018, Iowa has a fixed conformity date of January 1, 2015, which effectively decouples Iowa from the IRC § 163(j) limitation. For 2019, the fixed conformity date is March 24, 2018, which couples Iowa to the IRC § 163(j) limitation. For 2020, Iowa becomes a rolling conformity state[86] and couples with the IRC § 163(j) limitation.

C. Missouri's Response

As a rolling conformity state,[87] Missouri has passively adopted the IRC §163(j) limitations. While Missouri is capable of fully or partially

86. IOWA CODE § 422.3 (effective 2020).
87. *See* MO. ANN. STAT. §§ 143.091 & 143.431.1 (2018).

decoupling from the IRC §163(j) limitations, it has not done so.

Indiana's Response

Indiana elected to decouple from the interest limitation under IRC § 163(j). Indiana law provides that interest is deductible in the first year in which it was actually paid or accrued. This will result in a first-year subtraction of the disallowed portion, with a subsequent add back in later years when the interest is allowed for federal purposes.[88]

For directly related interest expenses, the amount of interest disallowed is determined and added back in the year in which it was incurred. This includes any interest that may have been disallowed because of IRC § 163(j). In any year after the year in which the interest was first incurred, no modification is required.

D. Predictions of How Taxpayers Will Respond

The effect of this TCJA provision will likely be marginal. It may affect taxpayers using borrowed moneys to purchase property for expensing. However, the federal effect is merely to delay the deduction rather than to disallow the deduction, so the effect will be minimized.

X. THE TRANSITION TAX

The TCJA amends IRC Section 965 to create a Transition Tax.[89] Prior to the TCJA's transfer of the U.S. to a territorial tax system, multinational corporations had an incentive to keep earnings by their foreign subsidiaries overseas.[90] Repatriation of this foreign income to the U.S. parent (e.g. by dividend to the U.S. parent) was taxable, and multinational corporations could in some situations defer or avoid paying tax on those earnings by

88. *See e.g.*, IND. CODE 6-3-13.5(a)(24) (2018).

89. *See* Phillips & Wlodychak, *supra* note 31, at 12.

90. Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System*, TAX NOTES (June 29, 2018), https://www.taxnotes.com/beps-expert/tax-cuts-and-jobs-act/new-non-territorial-us-international-tax-system/2018/07/17/28613#sec-2.

refraining from repatriating income.[91] With the change to a territorial tax system that generally does not tax foreign dividends, the TCJA attempts to end this "lock-out effect[.]"[92]With the Transition Tax, the TCJA also addresses the foreign earnings that had accumulated for a period of the past 30-or-so years.[93] Whether a taxpayer repatriates its foreign earnings from that time period or not, a portion of those earnings will be deemed to have been repatriated, and will be subject to a tax with two different effective rates dependent upon foreign cash position.[94]

The operation and certain limitations of the Transition Tax provision can be understood by a review of its technical terminology. Statutorily, the Transition Tax provision requires a U.S. taxpayer to increase its Subpart F Income by a pro rata share of the "accumulated post-1986 deferred foreign income" of the taxpayer's "deferred foreign income corporation[s.]"[95] A "deferred foreign income corporation" is a "specified foreign corporation" with positive accumulated post-1986 deferred foreign income.[96] A specified foreign corporation (SFC), generally, is a foreign corporation owned 10% or more by a U.S. shareholder, excluding passive foreign investment companies.[97] "Accumulated post-1986 deferred foreign income[,]" in summary, consists of certain earnings and profits of an SFC between December 31, 1986 and either November or December 2017.[98]

The increase in the U.S. taxpayer's Subpart F income by a share of the

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91. *See* U.S. S. COMM. FIN., TAX TALK: THE $2 TRILLION LOCKOUT (2017), https://www.finance.sen
ate.gov/ chairmans-news/tax-talk-the-2-trillion-lockout.

92. *Id.*

93. *Cf.* I.R.C. § 965(a) (2018); I.R.C. § 965(d)(3) (2018).

94. I.R.C. § 965(c) (2018). In this section of the Article, the term "effective rate" or "effectively taxed" are generally used to refer to the "equivalent" percentages described in IRC § 965(c); the true effective tax rate on a taxpayer's income would require consideration of other factors.

95. Individual Tax Reform & Alt. Minimum Tax, Pub. L. No. 115-97, § 14103, 131 Stat. 2054 (2017) (amending IRC § 965).

96. I.R.C. § 965(d)(1) (2018).

97. I.R.C. § 957(a) (2018); I.R.C. § 951(b) (2018); I.R.C. § 965(e) (2018).

98. *See* Individual Tax Reform & Alt. Minimum Tax, Pub. L. No. 115-97, § 14103, 131 Stat. 2054 (2017) (amending I.R.C. §§ 965(a)(1) – (2) and 965(d)).

accumulated post-1986 deferred foreign income amount is partially reduced by the U.S. taxpayer's "aggregate foreign E&P deficit," which is allocated among the U.S. taxpayer's deferred foreign income corporations.[99] Broadly speaking, if, as of November 2, 2017, an SFC had a deficit in its earnings and profits during the period between December 31, 1986 and November 2, 2017, a share of that amount will lead to an aggregate foreign E&P deficit.[100] The bottom line is that U.S. taxpayers who owned poorly performing SFCs are provided some relief from the increase in their reportable income that would otherwise occur by reason of the Transition Tax provision.

U.S. taxpayers who increase their gross income as a result of the Transition Tax provision are provided with a tax deduction which is calculated to ensure that the income increase is effectively taxed at either 8% or 15.5%.[101] The equivalent of a 15.5% tax rate is applied to the proportion of the income increase that is attributed to the SFCs' aggregate foreign cash position, while the 8% rate equivalent is applied to the proportion attributed to the SFCs' noncash assets.[102] Further reducing their liability under the Transition Tax, U.S. taxpayers subject to the Transition Tax are also provided with a limited foreign tax credit connected with the inclusion of their deemed repatriation in income.[103] The impact of the Transition Tax is increased because of the IRC Section 78 Gross-Up, a federal tax provision which treats deemed paid foreign taxes as though

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99. I.R.C. § 965 (2018).

100. *See* Thompson Reuters Tax & Acct., *Publication Explains How to Calculate (Deemed Repatriation) Transition Tax*, THOMPSON REUTERS (Apr. 12, 2018), https://tax.thomsonreuters.com/me dia-resources/news-media-resources/checkpoint-news/daily-newsstand/publication-explains-how-to-calculat e-deemed-repatriation-transition-tax/; I.R.C. § 965(b)(3)(B) (2018).

101. I.R.C. § 965(c) (2018); see *supra* note 94 (regarding the use of the term "effectively taxed" in this section).

102. I.R.C. § 965(c) (2018).

103. *See* I.R.C. § 965(g) (2018); *see also* I.R.S., QUESTIONS & ANSWERS ABOUT REPORTING RELATED TO SEC. 965 ON 2017 TAX RETURNS (2018) [hereinafter QUESTIONS & ANSWERS ABOUT REPORTING], https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns.

they were dividends paid by a foreign corporation to the U.S. parent.[104] In connection with the Transition Tax provision, the IRC Section 78 Gross-Up applies to a limited amount of the deemed-paid taxes as specifically addressed in IRC 965(g)(4).[105]

The Transition Tax provision applies for the last tax year of the U.S. taxpayer's SFCs beginning before January 1, 2018, and, as written, would affect the U.S. taxpayer's federal taxable income for the tax year(s) in which its SFCs' tax years end.[106] Taxpayers may elect to pay their Transition Tax in ballooning-percentage installments over eight tax years.[107] Although installment payments of the Transition Tax may be drawn out over these years, the Transition Tax will affect an ordinary corporate taxpayer's tax liability for only a limited number of tax years: 2018, 2017, and/or, potentially in some situations, 2016.[108] Similar to the GILTI provision described in the section below, the Transition Tax will not only affect C-corporations, but also individual taxpayers, S-corporations and partnerships, estates and trusts, real estate investment trusts, regulated investment companies, and exempt organizations (such as 501(c)(3) nonprofits).[109] However, this Article will primarily discuss the Transition Tax in the context of C-corporations.

The increase in Subpart F Income caused by Section 965(a) of the Transition Tax provision, and reduced by the deficit amounts mentioned in Section 965(b), is referred to throughout this section as the "Section 965(a) Inclusion Amount," following IRS terminology.[110] The deduction, described above, which is permitted to partially offset the Section 965(a)

104. *See* I.R.C. § 78 (2018).
105. *See* I.R.C. § 965(g)(4) (2018); I.R.S., PUBL'N 5292: HOW TO CALCULATE SEC. 965 AMOUNTS & ELEC. AVAILABLE TO TAXPAYERS (2018) [hereinafter HOW TO CALCULATE SEC. 965 AMOUNTS], https:/ /www.irs.gov/pub/irs-pdf/p5292.pdf.
106. *See* Phillips & Wlodychak, *supra* note 31, at 12; Thompson Reuters Tax & Acct., *supra* note 100.
107. I.R.C. § 965(h) (2018).
108. *See* HOW TO CALCULATE SEC. 965 AMOUNTS, *supra* note 105.
109. *See* QUESTIONS & ANSWERS ABOUT REPORTING, *supra* note 103.
110. *See* HOW TO CALCULATE SEC. 965 AMOUNTS, *supra* note 105.

Inclusion Amount in order to tax it at an equivalent of a 15.5% or 8% rate, is referred to as the "Section 965(c) Deduction."[111]

IRS guidance for tax year 2017 differs somewhat from the statutory operation of the Transition Tax provision described above. On March 13, 2018, the IRS released Q&A guidance on the Transition Tax provision.[112] The IRS instructs corporate taxpayers not to enter the various components of the Transition Tax provision (including the Section 965(a) Inclusion Amount and the Section 965(c) Deduction) directly on Form 1120 itself or Schedule C.[113] Corporations instead must, among other things, enter these components on a separate 'IRC 965 Transition Tax Statement.'[114] The Transition Tax amount is then calculated and reported on the Form 1120 line for the corporation's total federal income tax.[115] As discussed later in this section, this method of reporting the components of the Transition Tax bypasses the Form 1120 line for reporting federal taxable income, potentially affecting the states that begin their calculation of state income tax using federal taxable income.[116]

The IRS has changed the manner of reporting the Transition Tax for subsequent tax year(s). The Form 1120 for tax year 2018 shows that the Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, will be included in a corporation's federal taxable income on Form 1120.[117] The 2018 Form 1120 includes specific lines to report amounts from Form 965-B, among other things.[118] The IRS has also made available Form 965 and its schedules, to be used in reporting amounts related to the Transition Tax.[119] Although the finalized 2018 instructions for Form 1120 are not

111. *Id.*
112. *See* QUESTIONS & ANSWERS ABOUT REPORTING, *supra* note 103.
113. *See id.*
114. *See id.*
115. *See id.*
116. *See id.*
117. *See* I.R.S., FORM 1120: U.S. CORP. INCOME TAX RETURN (2018) [hereinafter FORM 1120].
118. *See id.*
119. *See IRS Draft Tax Forms Search Page*, (entering "965" in the Find field), https://apps.irs.gov/app/p

available at the time of this writing, the above-mentioned 2018 tax forms strongly suggest that the filing of the Transition Tax Statement will be unnecessary for tax year 2018. The inclusion of schedules specific to the Transition Tax should help guide corporate taxpayers to a correct calculation of their Transition Tax amounts, while at the same time providing detailed information to the IRS. This change in the IRS reporting requirements related to the Transition Tax may in turn require states to change their related reporting requirements.

XI. HOW STATES ARE RESPONDING GENERALLY TO THE TRANSITION TAX

A. Rolling Conformity States

One might expect that, because it increases Subpart F Income, the Transition Tax provision would generally increase the tax base of rolling conformity states for tax years in which the taxable income or adjusted gross income of taxpayers is affected by the Transition Tax provision. However, the IRS administration of the Transition Tax for 2017 creates a key issue within rolling conformity states that begin their tax calculation using federal taxable income (Form 1120, Line 30) or taxable income before NOLs and special deductions (Form 1120, Line 28).[120]

Under the IRC 965 Transition Tax Statement and IRS Q&A Guidance for 2017, the Section 965(a) Inclusion Amount and the Section 965(c) Deduction are entered on a separate form and do not affect taxable income on Line 28 or Line 30.[121] Ernst & Young has identified that, while this raises "another level of uncertainty[,]" these return changes "do nothing to change the federal statute."[122] Some states have issued guidance on this

icklist/list/draftTaxForms.html;jsessionid=XtT1a1M1fYXmxSrXKB1fMqU4pFqNqdcpLSEZUFi6.-?value=965&criteria=formNumber&submitSearch=Find.

120. *Cf.* FORM 1120, *supra* note 114.

121. *See* QUESTIONS & ANSWERS ABOUT REPORTING, *supra* note 99.

122. *IRS Reporting Guidance on Section 965 Transition Tax Has State Implications*, ERNST &

issue and taken a similar view: although not directly reported as affecting federal taxable income on federal Form 1120, the Transition Tax provision changes Subpart F Income (and therefore federal taxable income) for state purposes.[123] Thankfully, based on the tax year 2018 forms available at the time of this writing, this issue may not affect tax year 2018.

A related issue also arises for rolling conformity states. Because the entire Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, is realized and included in taxable income in one, or only a few, year(s), one might expect state income tax liability to sharply increase in those year(s) unless the state permits installment payments similar to the TCJA's eight-year installment payment provision.[124] To date, at least Oklahoma and Utah have passed legislation permitting a similar installment payment regime.[125] Note that this issue need not arise for real estate investment trusts (REITs); under IRC 965(m), if the REIT so elects, the Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, is recognized in the REITs' gross income over a period of eight years.[126]

YOUNG: TAX NEWS UPDATE U.S. ED. (Mar. 22, 2018), https://taxnews.ey.com/news/2018-0622-irs-reporting-guidance-on-section-965-transition-tax-has-state-tax-implications.

123. *See, e.g.*, R.I. DEP'T REVENUE DIV. TAX'N, DIV. FILES, AS FINAL, ITS REG. ON SEC. 965 INCOME (2018); ALA. DEP'T REVENUE, NOTICE: IRC SEC. 965 — GUIDANCE FOR CORPS. FILERS, P'SHIPS, S CORPS., AND INDIVIDUAL TAXPAYERS (2018); CONN. DEP'T REVENUE SERV., OFF. OF THE COMM'R GUIDANCE REGARDING THE CONN. TREATMENT OF THE FED. REPATRIATION TRANSITION TAX UNDER IRC § 965 (2018); PA. DEP'T. OF REVENUE, INFO. NOTICE CORP. TAXES & PERSONAL INCOME TAX, 2018-1: TAX CUTS AND JOBS ACT OF 2017 (2018).

124. *Cf.* I.R.C. § 965(a) (generally, the subpart F income of a deferred foreign income corporation is only increased under IRC 965 in its last taxable year beginning before 2018); HOW TO CALCULATE SEC. 965 AMOUNTS, *supra* note 105 (discussing the reporting a Section 965(a) Inclusion Amount on the 2017 or 2018 tax return, and stating that in some circumstances Section 965 amounts must be reported on the 2016 tax return).

125. *See* Maria Castilla, *State-by-State Legislation in Response to Federal Tax Reform*, CPA PRACTICE ADVISOR (July 11, 2018), https://www.cpapracticeadvisor.com/news/12420108/state-by-state-tax- legis
lation-in-response-to-federal-tax-reform.

126. *See* I.R.C. § 965(m) ("if the real estate investment trust elects the application of this subparagraph, notwithstanding subsection (a), any amount required to be taken into account under section 951(a)(1) by reason of this section shall[. . .] be included in gross income as follows: [an 8-year payment schedule is provided]").

Finally, a number of states provide a deduction for foreign dividends and/or Subpart F Income.[127] These deductions would be applicable – in whole or in part – to the Section 965(a) Inclusion Amount, which is treated as a deemed dividend because it constitutes Subpart F Income.[128] A relevant publication estimates that only 16 states may tax income connected with the Transition Tax provision.[129]

B. Fixed Conformity States

Fixed conformity states that have not updated their conformity to include the 2017 changes to the Internal Revenue Code would not have their income tax base affected by the Transition Tax.[130]

However, fixed conformity states that have made a timely update to their conformity date will generally be "in the same boat" as rolling conformity states regarding the issues described above.

Idaho is an example of a state that has updated its conformity date in time to be affected by the Transition Tax. On February 9, 2018, Idaho's House Bill 355 was signed into law, conforming Idaho to the Internal Revenue Code as of December 21, 2017 (although applying the Transition Tax provision "as in effect on December 31, 2017").[131] This affects Idaho's "water's edge" corporate tax filers, requiring that they include the Section 965(a) Inclusion Amount in their Idaho tax base.[132] Idaho

127. *Cf.* Phillips & Wlodychak, *supra* note 31, at 12-13.
128. *Cf. Id*
129. *See id.*
130. *See Tax Reform Progress Report: April 2018*, BAKER TILLY: INSIGHTS (Apr. 25, 2018), http://bak ertilly.com/insights/tax-reform-progress-report-april-2018/; Phillips & Wlodychak, *supra* note 31, at 12.
131. H.B. 355, 64th Leg., 2d Reg. Sess. (Idaho 2018); IDAHO STATE TAX COMM'N, IDAHO CONFORMITY AND TAX REFORM, (2018).
132. *See id.*; *Recent Idaho Law Amendments Provide Income Tax Rate Reductions and Amend IRC Conformity*, DELOITTE: EXTERNAL MULTISTATE TAX ALERT (May 31, 2018)[hereinafter DELOITTE: EXTERNAL MULTISTATE TAX ALERT],

continues to provide a partial foreign dividends exclusion, limiting the impact on Idaho's tax base.[133] Similarly, on April 14, 2018, Kentucky updated its conformity date with the IRC to December 31, 2017, thereby generally conforming to the TCJA and Section 965.[134]

C. Selective Conformity States

Among the five selective conformity states, only California was expected to receive a tax base increase as a result of the Transition Tax provision as of early 2018.[135] However, California has since publicized its position that it does not conform to IRC § 965, and related amounts should not be reported by taxpayers when filing California returns.[136]

Pennsylvania, which conforms to the calculation of taxable income used by the federal government, is another notable example within the selective conformity states group.[137] On April 20, 2018, Pennsylvania's Department of Revenue issued an information notice indicating that the Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, must be included in the state tax base.[138] Pertaining to the IRC 965 Transition Tax statement issue affecting rolling conformity states, Pennsylvania's notice points out that the Section 965(a) Inclusion Amount and Section 965(c) Deduction

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https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax
/us-tax-recent-idaho-law-amendments-provide-income-tax-rate-reductions-and-amend-irc-conformity.pd
f.

133. *See* IDAHO CODE § 63-3027c (2018); DELOITTE: EXTERNAL MULTISTATE TAX ALERT, *supra* note 132.

134. *See* Bruce Chang, *Tax Reform Friday: Kentucky Addresses Conformity to Tax Cuts and Jobs Act with House Bill 487*, BLOOMBERG: SALT TALK BLOG (May 11, 2018), https://www.bna.com/tax-reform
-friday-b73014475835/.

135. Phillips & Wlodychak, *supra* note 31, at 13.

136. CAL. FRANCHISE TAX BD., CAL. GUIDANCE – TAXABLE YEAR 2017 IRC SEC. 965 REPORTING, (revised May 22, 2018), https://www.ftb.ca.gov/forms/updates/2017/ircsection965.pdf.

137. *See* PA. DEP'T OF REVENUE, *supra* note 123; 72 PA. STAT. & CONS. STAT. ANN. § 7401(3)(1)(a) (West 2018).

138. PA. DEP'T OF REVENUE, *supra* note 120.

are not excluded from Pennsylvania's tax base simply because they are not included in Form 1120, Line 28 taxable income.[139] Similar to other states, Pennsylvania offers a dividends received deduction for at least a part of the taxpayer's Subpart F Income, reducing the impact of the Transition Tax on Pennsylvania's corporate taxpayers.[140]

While Arkansas and Mississippi both join California in not including the Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, in their tax base, New Jersey joins Pennsylvania in including the Amount, but will also grant a sizeable dividend deduction.[141]

D. Missouri Responses

Missouri, as a rolling conformity state which begins its calculation of state income tax with a corporation's federal taxable income or an individual's federal adjusted gross income, will be impacted by the Transition Tax provision. Although, for tax years 2016 and 2017, it is not included on Form 1120, Line 30 federal taxable income, corporations paying Missouri corporate income tax will generally be required to include their Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, in federal taxable income.[142] This will appear to increase Missouri's tax base, but, as discussed below, multiple facets of Missouri law will act to fully, or partially, eliminate this increase.

Missouri offers the Missouri Dividends Deduction, which permits corporate taxpayers to deduct "corporate dividends from sources within

139. See *Id.*
140. *See id.* at 3-4.
141. *State Conformity to Federal Section 965 Transition Tax*, INTUIT PROCONNECT (Sept. 6, 2018), ht
tps://accounttants-community.intuit.com/articles/1747665-state-conformity-to-federal-section-965-transition-tax#AR.
142. *See* MISSOURI DEP'T OF REVENUE, TAX CUTS AND JOBS ACT: IRC SECTION 965 TRANSITION TAX: TAX YEARS 2016 AND 2017 1-2, *available at* https://dor.mo.gov/media/docs/TCJA.pdf (last accessed January 14, 2019).

Missouri."[143] A 1990 case from the Missouri Supreme Court, involving a taxpayer using the apportionment method provided by the Multistate Tax Compact, found that Subpart F Income and the IRC Section 78 Gross-Up, to the extent they were business income, were to be treated as dividends for purposes of the Missouri Dividends Deduction.[144] Both of these items will increase as a result of the Transition Tax provision. Taxpayers using the Multistate Tax Compact apportionment method may be put in a win-win position. On the one hand, the increase in income from the Transition Tax provision may be subject to the Missouri Dividends Deduction, which could eliminate such increase from the Missouri tax base.[145] On the other hand, the taxpayer may argue that the increase is nonbusiness income, reducing the taxpayer's income apportioned to Missouri under Missouri's instructions.[146] Whether the Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, actually constitutes nonbusiness income is an open question, and may depend on particular facts and circumstances.

Missouri also offers different single-factor apportionment methods to corporate taxpayers, relying on sales or certain other measures of state activity, to determine income apportionable to Missouri.[147] Under a single-factor apportionment method, taxpayers are instructed to exclude non-Missouri dividends or wholly passive investment income from outside Missouri when calculating their apportionment factor.[148] It is not entirely clear whether, and under what circumstances, the Section 965(a) Inclusion

143. MO. REV. STAT. § 143.431.2. (2018).
144. Dow Chem. Co. v. Dir. Revenue, 787 S.W.2d 276, 286 (Mo. 1990).
145. *Cf.* MISSOURI DEP'T OF REVENUE, TAX CUTS AND JOBS ACT: IRC SECTION 965 TRANSITION TAX: TAX YEARS 2016 AND 2017 1-3, *available at* https://dor.mo.gov/media/docs/TCJA.pdf (last accessed January 9, 2019) ("For corporate taxpayers using . . . Three Factor Apportionment, . . . an apportioned share of this amount may be subtracted through the Missouri Dividends Deduction[.]").
146. *Cf. id.* at 3; *see* Missouri Department of Revenue, Tax Form MO-1120 Instructions for Tax Year 2017, at 9, 11 *available at* https://dor.mo.gov/forms/MO-1120%20Instructions_2017.pdf (last accessed January 13, 2019).
147. *Cf.* MO. DEP'T. REVENUE, FORM MO-MS (2017).
148. *See* MO. DEP'T. REVENUE, FORM MO-MS & INSTRUCTIONS (2017), *available at* https://dor.mo.g
ov/forms/MO-MS_2017.pdf.

Amount less the Section 965(c) Deduction may be excluded from this calculation. Where attributable to Missouri sources, single-factor filers may use their apportioned share of the Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, in the Missouri Dividends Deduction.

The Multistate Tax Compact apportionment method uses three factors to determine a corporation's activity in Missouri, including Missouri sales divided by the corporation's overall sales.[149] A corporation's Section 965(a) Inclusion Amount, less the Section 965(c) Deduction, would only be considered "sales" if such treatment is consistent with certain Missouri regulations.[150] This same amount is not anticipated to constitute sales under Missouri's single-factor apportionment methods.[151]

Missouri is one of four states that provide a partial or full deduction for federal income taxes (the "FIT Deduction").[152] While a recent legislative change in Missouri alters the FIT Deduction for individuals,[153] the corporate FIT Deduction remains in place at 50% of the corporation's federal tax liability (calculated without regard to the foreign tax credit).[154] Because the Transition Tax is expected to increase the federal income tax of individuals and corporations subject to it, while also increasing the foreign tax credit amount, an individual or corporation's Missouri FIT Deduction will increase during the initial year in which it becomes liable

149. The three factors used under the Multistate Tax Compact apportionment method are the ratios of a corporation's Missouri property, payroll, and sales over the corporation's total property, payroll, and sales. *See* MO. DEP'T. REVENUE, FORM MO-MS (2017).
150. *See* MO. DEP'T OF REVENUE, *supra* note 149, at 2; MO. CODE REGS. ANN. tit. 12 § 10-2.045(19) (2018); MO. CODE REGS. ANN. tit. 12 § 10-2.075(57) (2018). Fair apportionment concerns may lead to disallowing the treatment of this income as sales. *See* MO. CODE REGS. ANN. tit. 12 § 10-2.075(43) (2018).
151. *See* MO. DEP'T OF REVENUE, *supra* note 149, at 2,; *cf.* MO. REV. STAT. § 143.451. (2018).
152. *State Tax Considerations of Federal Tax Reform*, PA. INST. OF CERTIFIED PUB. ACCTS. (Apr. 24, 2018), https://www.picpa.org/articles/picpa-news/2018/04/24/pa-cpa-journal-tax-reform-guide-state-ta
x-considerationns-of-federal-tax-reform.
153. *Enacted Missouri Legislation Includes Personal Income Tax Changes*, *Multistate Tax Alert*, DELOITTE: ANALYSIS (July 31, 2018), https://www2.deloitte.com/us/en/pages/tax/articles/enacted-missouri-legislation-includes-personal-income-tax-changes.html.
154. *See* MO. REV. STAT. § 143.171.3 (2018).

for the Transition Tax. A taxpayer may not extend the period over which it is eligible for an increased FIT Deduction by paying the Transition Tax in installments, as the entire income tax liability from the Transition Tax accrued in the first year that a Transition Tax payment was due.[155] This is with the exception of REITs, which may recognize the increase in federal taxable income in installments.[156] REITs do not incur income tax liability from the Transition Tax until the increase in federal taxable income is recognized, and therefore a REIT may include its resultant Transition Tax liability in the FIT Deduction for each 'installment' year.

Overall, in light of the Missouri Dividends Deduction, the FIT Deduction, and Missouri's apportionment rules, the Transition Tax provision may end up reducing the Missouri corporate income tax base for the years in which corporate taxpayers are subject to it.

For better or worse, tax year 2018 has passed for calendar-year corporate income tax filers without an enacted legislative response by Missouri to the Transition Tax. At least one legislative proposal attempted to eliminate the corporate FIT Deduction in Missouri, a possible approach recommended by Missouri's Director of Revenue in a relatively recent publication.[157] Possible responses by Missouri to the Transition Tax provision could have included:

- Decoupling from the Transition Tax provision to eliminate its potentially negative effects on Missouri's 2018 tax base;
- Expressly excluding deemed dividends from the Missouri Dividends Deduction, in order to better focus this deduction on dividends

155. *See* Missouri Department of Revenue, Policy Guidance, "Tax Cuts and Jobs Act: IRC Section 965 Transition Tax: Tax Years 2016 and 2017," 1-3, *available at* https://dor.mo.gov/media/docs/TCJA.p
df (last accessed January 9, 2019) ("[t]he taxpayers *must not* include on any of MO-1120, part 3, Lines 1 through 3 the amount of future Transition Tax installments").
156. *See* I.R.C. § 965(m)(2)(b)(iii) (2018).
157. *See* S.B. 611, 99th Gen. Assemb., 2d Reg. Sess. (Mo. 2018); Joel Walters, *Tax Policy Reform: Issues to be Addressed to the Benefit of All Missourians*, 1 BUS. ENTREPRENEURSHIP & TAX L. REV. 427, 465 (2017).

from corporations within the U.S.;[158]

- Limiting Missouri's FIT Deduction to only federal income tax liability both incurred and paid in the same tax year, to minimize the effects of the Transition Tax on the FIT Deduction in tax year 2018.

E. Indiana Responses

For IRC § 965 income, Indiana requires the reporting of the gross amount of income.[159] The exact addback depends on the entity type. For individuals and REITs, the net amount of § 965 income is reported on their individual or entity tax return. The required addback for individuals and REITs is the deduction claimed under IRC § 965(c). For nonresident individuals that receive § 965 income from pass-through entities, only the apportioned amount is included in Indiana adjusted gross income.

For regular C corporations, estates, and trusts, the § 965 income is not, at least for tax year 2017, directly reported on the federal income tax return. Indiana requires an addback of Line 1 on the IRC 965 Transition Tax Statement.[160]

For financial institutions, IC 6-5.5-1-2 requires taxpayers to deduct income derived from outside the United States. In this case, the IRC § 965 income is considered to be derived from outside the United States; however, since the income is not, at least for tax year 2017, included on the federal income tax return, it is neither included nor deducted on the Indiana return.[161]

Regular C corporations qualify for a foreign-source dividend deduction based on their ownership in the relevant controlled foreign corporation under IC 6-3-2-12. For apportionment purposes under IC 6-3-2-2(t) and IC

158. *But, see,* Kraft General Foods, Inc. v. Iowa Dept. of Revenue and Finance, 505 U.S. 701 (1992).
159. IND. CODE § 6-3-1-3.5 (2018).
160. While Indiana acknowledges that the net amount of income would otherwise be in federal taxable income, Indiana tends to be cautious with regard to off-return inclusions.
161. However, to the extent that a financial institution does include the income, there would be an automatic deduction.

6-3-2-2.2, two separate rules apply. For partnerships and S corporations, the receipts are not included in the entity's apportionment calculation. For C corporations, the income net of the foreign dividend deduction is considered a receipt for apportionment denominator purposes. If the deemed recipient is domiciled in Indiana, the income net of the foreign dividend deduction is included in the apportionment numerator.

If a taxpayer makes an election to defer payment of federal income tax on § 965 income, Indiana does not follow that election. Instead, any tax must be paid by the regular due date. For REITs, Indiana does recognize the eight-year inclusion under IRC § 965(m).

F. Prediction of Taxpayer Response

While the global provisions of the TCJA can be expected to have a significant forward-looking impact on international businesses, the Transition Tax itself is not designed to have a significant economic effect on the behavior of taxpayers subject to it. Although the Transition Tax may affect the taxpayer's 2016, 2017, and/or 2018 tax years, the amount by which the taxpayer may be impacted is generally fixed as of November 2, 2017 or December 31, 2017.[162] The general responses of taxpayers to the Transition Tax provision may include making elections to use the eight-year installment plan and asking questions for clarification of the provision.

While no hard statistics are readily available regarding the number of taxpayers who have elected to pay the Transition Tax using the eight-year installment plan, it is difficult to see the downside in making such an election. Under the eight-year installment plan, the tax liability resulting from the Transition Tax provision must be paid in the following amounts: 8% in the first five years; 15% in the sixth year; 20% in the seventh year; and 25% in the eighth year.[163] As long as the installment payments are

162. *See* I.R.C. § 965(a)(1)-(2) (2017).
163. I.R.C. § 965(h) (2017).

timely, there is no provision stating that interest accrues on these installments.[164] Thus, consistent with the concept of the 'time value of money,' a corporation benefits by this interest-free delay of tax payment.[165]

Taxpayers subject to the Transition Tax provision in 2018 may be incentivized to shift a proportion of their apportionable income-producing activity to states which provide favorable treatment to the Net Deemed Repatriation Amount or do not include it in their tax base. However, because the Transition Tax is generally intended to be a one-off, or at least fairly temporary, alteration to a corporation's tax liability, it seems less likely to affect a corporation's long term decision-making on where within the U.S. to locate its taxable operations for income tax purposes.

G. Conclusion

The Transition Tax is an important component of the shift to the territorial system of taxation caused by the TCJA. Instead of letting off 'scot-free'[166] those taxpayers that have retained earnings in overseas subsidiaries in an effort to avoid U.S. taxation, the Transition Tax effectively taxes this income, albeit at a lower rate. While the Transition Tax is backward-looking, directed at the behavior of multinational corporations and other specific foreign corporation owners prior to 2018, the GILTI, or global intangible low-taxed income, provision – discussed next – is a forward looking global component of the TCJA.

XII. THE GILTI PROVISION

164. *See* I.R.C. § 6601(2018) (imposing interest on taxes not paid "on or before the last date prescribed for payment"). *Cf.* QUESTIONS & ANSWERS ABOUT REPORTING, *supra* note 104 (referring to interest on accruing untimely installment payments for individuals).

165. Although REITs benefit from the deferral of the recognition of the Section 965(a) Inclusion Amount, references to corporations in the above paragraph are meant to apply to corporations other than REITs organized as corporations.

166. This phrase is particularly relevant, as its origin refers to being tax-free. *See See* Katherine Connor Martin, *What is the Origin of the Term 'Scot-free'?*, OXFORD DICTIONARIES (Apr. 15, 2015), https:// blog.oxforddictionaries.com/2015/04/15/scot-free-origin/.

Under the TCJA, for tax years beginning after 2017, a U.S. taxpayer (the "parent") who maintains controlled foreign corporations (CFCs) may be required to include in its income the CFC's "global intangible low-taxed income," or GILTI.[167] In short, GILTI is the parent's "Net CFC Tested Income" minus a certain fictional normal return rate referred to as the "Net Deemed Tangible Income Return."[168] Net CFC Tested Income is a netted part of the income of the parent's CFCs; the CFCs' income is subject to modifications which, among other things, exclude foreign income subject to an effective foreign tax rate of 90% of the U.S. tax rate.[169] The Net Deemed Tangible Income Return is calculated as 10% of the CFCs' "qualified business asset investment" (QBAI), composed of certain tangible assets held by the parent's CFCs, less certain interest expense.[170] Overall, by including GILTI in its income, a parent's federal income tax is increased.[171]

The requirement to include GILTI applies to "[e]ach person who is a United States shareholder of any controlled foreign corporation[.]"[172] In other words, the GILTI provision is not limited to C corporations, but also

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167. *See* I.R.C. § 951A (2017).

168. *See* Martin A. Sullivan, *Economic Analysis: More GILTI Than You Thought*, TAX NOTES (Feb. 13, 2018), https://www.taxnotes.com/tax-reform/economic-analysis-more-gilti-you-thought.

169. *See* Gavin Ekins *International Provisions in the Senate Tax Cuts and Jobs Act*, TAX FOUND. (Nov. 28, 2017), https://taxfoundation.org/international-provisions-senate-bill/; *see also* Elizabeth V. Zanet & Stanley C. Ruchelman, *A New Tax Regime for C.F.C.'s: Who is G.I.L.T.I.?*, 5 INSIGHTS 16, 20 (2018) [hereinafter Zanet & Ruchelman]; I.R.C. § 951A(c)(2)(A) (2017); I.R.C. § 954(b)(4) (2017).

170. *See* Elkins, *supra* note 169; Zanet & Ruchelman, *supra* note 169, at 20.

171. The complexity of GILTI is well illustrated by the use of sigma notation in calculating various aspects of the GILTI provision in Tax Notes' *Economic Analysis: More GILTI Than You Thought*. *See* Sullivan, *supra* note 166. For example, to calculate the deemed paid foreign tax utilized when determining the Section 78 Gross-Up associated with GILTI, Mr. Sullivan gives the expression: "DPFT = $\sum^{N1}$ T□□□□□□Ti * INCL%" where DPFT signifies the deemed paid foreign tax, 1 through N1 signify a U.S. Shareholder's CFCs having positive tested income, TDPFTi signifies "taxes paid by CFCi with positive tested income[,]" and INCL% signifies the inclusion percentage which Mr. Sullivan calculates using another equation containing sigma notation.(Inset citation).

172. *See* I.R.C. § 951A (2018).

applies to various other business forms subject to federal income tax as well as individuals who own or constructively own 10% or more of the value or voting power of all shares of a foreign corporation.[173] Although this section will focus primarily on the GILTI provision's impact on C corporations, the impact on other businesses and individuals should be kept in mind.

The tax impact of the inclusion of GILTI is increased by the IRC § 78 Gross-Up, although U.S. parents who are not corporate taxpayers would not be subject to the IRC § 78 Gross-Up.[174] The impact of the inclusion of GILTI in a taxpayer's income is reduced by a deduction in the amount of 50% of: (i) the GILTI amount, plus (ii) the IRC 78 Gross-Up amount attributable to GILTI.[175] This deduction is provided under IRC § 250. For tax years beginning after 2025, the deduction amount will be reduced to 37.5% of the value of a taxpayer's GILTI. The impact of GILTI is further reduced by the allowance of a foreign tax credit connected with the GILTI amount.[176] Taxpayers who are not C corporations are ineligible for the deduction, and may not even be eligible for the foreign tax credit connected with GILTI.[177]

In the tax year 2018 version of Form 1120, the IRS includes GILTI under "[d]ividends and inclusions" on Form 1120, Schedule C, and similarly includes the IRC § 250 deduction as a special deduction on that same schedule.[178] Thus, on Form 1120 itself, GILTI would be reported on Line 4, while the IRC § 250 deduction would be reported on Line 29b.[179] As we will see, this return-drafting choice may impact states differently depending on whether they conform to Line 28 taxable income or Line 30 taxable income for corporate income tax purposes. The IRS has also

173. *See* Sullivan, *supra* note 168; I.R.C. § 951(b) (2018).
174. *See* I.R.C. § 78 (2018).
175. I.R.C. § 250(a)(1)(B) (2018).
176. *See* Sullivan, *supra* note 168.
177. *See id.*
178. FORM 1120, *supra* note 114.
179. *See id.*

released an early version of Form 8992, apparently to be used in calculating a taxpayer's share of GILTI, and Form 8993, to be used in calculating the IRC § 250 deduction.[180]

The policy rationale behind the GILTI provision is well embodied by the Policy Highlights for the TCJA prepared by the House and Senate Conference Committee, stating that the TCJA:

Prevents American jobs, headquarters, and research from moving overseas by eliminating incentives that now reward companies for shifting jobs, profits, and manufacturing plants abroad.[181]

GILTI supports the goal of preventing the shifting of profits to foreign countries by penalizing U.S. taxpayers for either moving high-return producing property and operations into fairly low-tax foreign jurisdictions, or for maintaining such property and operations there.[182] High returns could be connected with intangible property, but, despite its name, GILTI does not only apply to income from intangibles.[183] Nevertheless, GILTI (at least when combined with the TCJA's Foreign Derived Intangible Income provision) functions as "a worldwide minimum tax on intangible income."[184] When enacting GILTI, Congress almost certainly had a desire to combat foreign IP-related tax incentives like Ireland's "Knowledge Development Box" or the U.K.'s "Patent Box," both of which reduce the effective tax rate, in their respective countries, on certain items of intangible income.[185]

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180. I.R.S., FORM 8992: U.S. SHAREHOLDER CALCULATION OF GLOB. INTANGIBLE LOW-TAXED INCOME (2018); I.R.S., FORM 8993: SEC. 250 DEDUCTION FOR FOREIGN-DERIVED INTANGIBLE INCOME & GLOB. INTANGIBLE LOW-TAXED INCOME (2018).

181. H. & S. CONF. COMM., 115TH CONG., POL'Y HIGHLIGHTS ON TAX CUTS & JOBS ACT (2017).

182. *Cf. GOP Tax Cuts and Job Act: Preview of the New Tax Regime*, DAVIS POLK & WARDWELL LLP (Dec. 20, 2017), https://www.davispolk.com/files/2017-12-20_gop_tax_cuts_jobs_act_preview_new_tax_regime.pdf (referring to GILTI as the "stick" in a "carrot and stick" approach).

183. *See* Sullivan, *supra* note 168.

184. *See* Kyle Pomerleau, *A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts & Jobs Act*, TAX FOUND. (May 3, 2018) [hereinafter Pomerleau], https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/.

185. *Cf. Knowledge Development Box*, REVENUE: COMM'RS, IRISH TAX & CUSTOMS, (June 12, 2017), https://www.revenue.ie/en/companies-and-charities/reliefs-and-exemptions/knowledge-

XIII. HOW STATES ARE RESPONDING GENERALLY TO GILTI

A. Rolling Conformity States

Because GILTI is included "in gross income" for a U.S. parent, states with rolling conformity should generally see an increase in their income tax base.[186] However, states that conform by using Form 1120, Line 30 federal taxable income will reduce the GILTI inclusion by the GILTI deduction under IRC § 250. Because the GILTI deduction would be included in the "special deductions" listed on Line 29b of the federal return, states deriving taxable income from Form 1120, Line 28 may not offset the GILTI inclusion by the IRC § 250 GILTI deduction.[187] States may also provide a deduction or exclusion removing GILTI from their tax base. A noteworthy issue in this regard is whether states will treat GILTI as Subpart F Income, and therefore potentially as a deemed dividend subject to the dividend deductions available in many states.[188]

Although the TCJA has a provision which treats GILTI as Subpart F Income for a limited number of purposes, GILTI is not specifically included in Subpart F Income.[189] Meanwhile, in the Transition Tax provision, the Section 965(a) Inclusion Amount was specifically described as affecting Subpart F Income.[190] This disparity, as well as the canon of legislative interpretation *expressio unius est exclusio alterius*, strongly suggests that GILTI will not be considered Subpart F Income by states in

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ox-kdb/index.aspx; *Corporate Tax: The Patent Box*, GOV.UK: HM REVENUE & CUSTOMS, (Jan. 1, 2007), https://www.gov.uk/guidance/corporation-tax-the-patent-box.

186. *See* I.R.C. § 951A(a) (2018); I.R.C. § 250 (2018); N.Y. DEP'T OF TAX'N & FIN., PRELIMINARY REP. ON THE FED. TAX CUTS & JOBS ACT (2018).

187. *See* Jeffrey A. Friedman et al., *Insight: Waiting for the Other Shoe to Drop: State and Local Tax Implications of Federal Tax Reform – International Tax Provisions*, BLOOMBERG (Mar. 9, 2018), https://www.bna.com/insight-waiting-shoe-n57982089695/; FORM 1120, *supra* note 114.

188. *Cf.* Phillips & Wlodychak, *supra* note 31, at 10.

189. *See* I.R.C. § 951A (2018).

190. *See* I.R.C. § 965(a) (2018).

applying their dividend deductions.[191] It should be no surprise, then, that a report detailing the expected effect of the GILTI provision on states by Ernst & Young assumed that only a small number of the rolling conformity states would exclude GILTI income from taxation.[192] However, states may still consider GILTI to be a deemed dividend based on the actual method by which GILTI is determined (*i.e.* an adjusted measure of the income of CFCs), and this might be supported by the placement of a GILTI inclusion on Form 1120 Schedule C alongside actual dividends.

Illinois, a rolling conformity state, has noted that a portion of GILTI will be excluded from its income tax base by reason of its foreign dividends subtraction modification.[193] This is partly consistent with Ernst & Young's prediction that GILTI will be excluded from Illinois' income tax base.[194] It is noteworthy that Illinois' foreign dividends subtraction modification specifically references "dividends received or deemed received . . . under Sections 951 through 964 of the Internal Revenue Code[.]"[195] The express reference to a range of statutes that included Section 951A, in which GILTI is codified, most likely played a role in Illinois arriving at this interpretation.

In January 2018, the New York Department of Taxation and Finance issued a report discussing, among other things, the impact of GILTI on New York's tax base.[196] The report found that, although GILTI is treated like Subpart F Income, it is not Subpart F Income and therefore not subject

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191. "[E]xpressing one item of [an] associated group or series excludes another left unmentioned." *N.L.R.B. v. SW Gen., Inc.*, 137 S. Ct. 929, 940 (2017) (internal citation and quotation removed).
192. *See* Phillips & Wlodychak, *supra* note 31, at 11.
193. ILL. DEP'T OF REVENUE, EXPLANATION OF THE IMPACT ON ILL. TAX REVENUE RESULTING FROM THE FED. TAX CUTS & JOBS ACT (2018), www.revenue.state.il.us/News/2018_Federal_Tax_Cuts_Impact.htm.
194. *See* Phillips & Wlodychak, *supra* note 31, at 11.
195. 35 ILL. COMP. STAT. ANN. § 5/203(b)(O) (2018).
196. N.Y. DEP'T OF TAX'N & FIN., RESPONSE TO THE FED. TAX CUTS & JOBS ACT (2018), https://www.tax.ny.gov/research/stats/stat_pit/preliminary-report-tcja-2017.htm; PRELIMINARY REP. ON THE FED. TAX CUTS & JOBS ACT, *supra* note 186.

to an exemption under its income tax law.[197] New York found that the full amount of GILTI, less the GILTI deduction under IRC § 250, would be included in New York's tax base. [198] On June 19, 2018, New York's Senate passed Senate Bill S8991A, which is designed to exclude GILTI (and the federal deduction related to GILTI) from New York's tax base.[199] The bill has not been subsequently passed by New York's Assembly at this time.[200]

B. Fixed Conformity States

Fixed conformity states that have not updated their conformity to include the changes to the 2017 Internal Revenue Code would not have their income tax base affected by the GILTI provision.[201] Fixed conformity states that have updated their conformity date in time would be analyzed similarly to rolling conformity states discussed above.

As with the Transition Tax Provision, Idaho is an example of a state that has updated its conformity date to the IRC in a way that affects the application of GILTI in Idaho state tax calculation.[202] On March 12, 2018, Idaho's House Bill 463 was enacted, conforming Idaho to the Internal Revenue Code as of January 1, 2018 for Idaho's 2018 tax year.[203] This affects Idaho's "water's edge" corporate tax filers, requiring that they include the GILTI amount in their Idaho tax base without reducing it by

197. PRELIMINARY REP. ON THE FED. TAX CUTS & JOBS ACT, *supra* note 186.
198. *Id.*
199. *See* S. 8991A, 2018 Legis. Sess. (N.Y. 2018).
200. *See id.*
201. *Cf. Tax Reform Progress Rep.*, BAKER TILLY: INSIGHTS (Apr. 25, 2018), http://bakertilly.com/insi
ghts/tax-reform-progress-report-april-2018/; Phillips & Wlodychak, *supra* note 31, at 12
202. *See* Diana Smith et al., *More States Respond to Federal Tax Reform*, MCDERMOTT WILL & EMERY: INSIDE SALT (Mar. 19, 2018), https://www.insidesalt.com/2018/03/more-states-respond-to-fede
ral-tax-reform/.
203. *See id.*

the GILTI deduction under IRC § 250.[204] Notably, Idaho's partial foreign dividends exclusion includes as dividends "[a]mounts included in income by reference to subpart F of . . . the Internal Revenue Code[.]"[205] While GILTI is not included in Subpart F Income, a defined term under IRC § 952, it is required to be included in a taxpayer's gross income under IRC § 951A, which does fall under Subpart F of the Internal Revenue Code.[206] It follows that Idaho's partial foreign dividends exclusion would apply to reduce GILTI's impact on Idaho's tax base.

C. Selective Conformity States

Each of the five selective conformity states was predicted by Ernst & Young to receive a tax base increase as a result of GILTI.[207] However, California's Franchise Tax Board has indicated that it does not conform to the TCJA's GILTI provision, and GILTI is therefore not expected to directly impact California's tax base.[208]

D. Missouri Responses

Missouri, as a rolling conformity state that begins its calculation of Missouri income tax with a corporation's federal taxable income or an individual's federal adjusted gross income, will be impacted by the GILTI provision. Because Missouri generally begins its calculation of Missouri corporation income tax with a corporation's Form 1120, Line 30 federal taxable income, the GILTI inclusion will be partially offset by the GILTI

204. *See id.*
205. 63 IDAHO CODE § 63-3027c (2018).
206. *See* I.R.C. § 952 952 (2012 & Supp. V 2017); I.R.C. § 951A (2012 & Supp. V 2017).
207. Phillips & Wlodychak, *supra* note 31, at 11.
208. *See* CALIF. FRANCHISE TAX BD., SUMM. OF FED. INCOME TAX CHANGES 2017 386 (2017), https:// www.ftb.ca.gov/law/legis/Federal-Tax-Changes/2017.pdf; CALIF. FRANCHISE TAX BD., PRELIMINARY REP. ON SPECIFIC PROVISIONS OF THE FED. TAX CUTS & JOBS ACT (2018), https://www.ftb.ca.gov/law/l
egis/Federal- Tax-Changes/CAPreliminaryReport3Provisions-Revise.pdf.

deduction under IRC § 250.[209] The GILTI inclusion offset in this way is referred to herein as the "Net GILTI Inclusion."

An important question under Missouri corporate income tax law is whether the Missouri Dividends Deduction will apply to the Net GILTI Inclusion. Unlike Illinois and Idaho's deductions/exclusions pertaining to foreign dividends, Missouri statutes do not specify particular sections or subparts of the IRC to which the Missouri Dividends Deduction applies.[210] The *Dow Chemical* case, discussed in the Transition Tax section above, applied the Missouri Dividends Deduction to deemed dividends, including Subpart F Income and the Section 78 Gross-Up amount.[211] At minimum, then, the amount of a corporation's Section 78 Gross-Up should be excluded from Missouri's tax base through the Missouri Dividends Deduction.[212] An unresolved issue in Missouri remains as to whether the Net GILTI Inclusion constitutes a deemed dividend that *Dow Chemical* would consider part of the Missouri Dividends Deduction.

Similar to the Transition Tax provision, corporate taxpayers using the Multistate Tax Compact apportionment method may argue that the Net GILTI Inclusion constitutes nonbusiness income, while taxpayers using one of Missouri's single-factor apportionment methods may assert that it is non-Missouri dividend income or wholly passive investment income from outside Missouri.[213] If successful, a taxpayer reporting the Net GILTI Inclusion would, under Missouri' instructions for these apportionment methods, reduce its Missouri income percentage, lowering its overall

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209. *Cf.* MO. DEP'T OF REVENUE, FORM MO-1120: MO. DEP'T OF REVENUE 2017 CORP. INCOME TAX RETURN (2017); MO. DEP'T OF REVENUE, ELECTRONIC FILING OPTIONS FOR CORP. TAX RETURNS (2017).

210. *See* MO. REV. STAT. § 143.431 (2018).

211. *See* Dow Chem. Co. v. Dir. Revenue, 787 S.W.2d 276, 286 (Mo. 1990).

212. This statement assumes that the corporate taxpayer is using the Multistate Tax Compact apportionment method. If taxpayers are able to subtract the Net GILTI Inclusion through the Missouri Dividends Deduction, corporate taxpayers using a single-factor apportionment method might be instructed differently.

213. *See generally* MO. DEP'T OF REVENUE, FORM MO-MS CORP. ALLOCATION & APPORTIONMENT OF INCOME SCHED. (2017); MO. DEP'T OF REVENUE, FORM MO-NBI NONBUSINESS INCOME SCHED. (2016).

amount of Missouri taxable income and thus its Missouri corporate income tax liability. If the Net GILTI Inclusion were considered a deemed dividend, it would most likely not be included in the sales or business transaction factor under Missouri's single-factor apportionment methods. The Net GILTI Inclusion may possibly be considered part of the sales factor under the Multistate Tax Compact apportionment method if it meets certain regulatory requirements.[214] The Net GILTI Inclusion would increase the federal income tax of the taxpayers subject to it, and this would in turn increase a Missouri taxpayer's FIT Deduction.[215]

There were no Missouri legislative enactments specifically addressing GILTI in 2018. As a response to GILTI, Missouri might possibly consider the following:

- Decoupling from the TCJA provisions regarding GILTI in order to limit its long-term impact;
- Expressly excluding deemed dividends from the Missouri Dividends Deduction, in order to better focus the deduction on dividends from corporations within the U.S.;[216]
- Eliminating the corporate and individual FIT Deduction.

E. Indiana Responses

For entities other than C corporations, Indiana adopted the federal inclusion of GILTI. For C corporations other than financial institutions, Indiana requires the addback of the 50% deduction under IRC §

214. *See* Pomerleau, *supra* note 184; MO. CODE REGS. ANN. tit. 12, § 10-2.075(57) (2018); MO. CODE REGS. ANN. tit. 12, § 10-2.075(64)(c) (2018); MO. CODE REGS. ANN. tit. 12, § 10-2.075(43) (2018).
215. *See* MO. REV. STAT. § 143.171 (2016). The foreign tax credit associated with GILTI would further impact the FIT Deduction.
216. *But cf. generally Kraft General Foods, Inc. v. Iowa Dept. of Revenue and Finance*, 505 U.S. 701 (1992).

250(a)(1)(B) in determining adjusted gross income.[217]

For financial institutions, IC 6-5.5-1-2 requires taxpayers to deduct income derived from outside the United States. In this case, GILTI is considered to be derived from outside the United States; however, GILTI will neither be included nor deducted on the Indiana return.

Indiana treats GILTI as a foreign-source dividend. Regular C corporations qualify for a foreign- source dividend deduction based on their ownership in the relevant controlled foreign corporation under IC 6-3-2-12. For apportionment purposes under IC 6-3-2-2(t) and IC 6-3-2-2.2, two separate rules apply. For partnerships and S corporations, the receipts are not included in the entity's apportionment calculation. For C corporations, the income after addback and net of the foreign dividend deduction is considered a receipt for apportionment denominator purposes. If the deemed recipient is domiciled in Indiana, the income after addback and net of the foreign dividend deduction is included in the apportionment numerator.

For purposes of the individual credit for taxes paid to another jurisdiction under IC 6-3-3-3, any foreign taxes paid would be eligible for a credit against state AGI as if the tax had been paid to a state. However, the credit is not available against Indiana local income tax.

E. Prediction of How Taxpayers Will Respond

Unlike the Transition Tax provision, the GILTI provision is designed to affect future taxpayer behavior by disincentivizing the movement of high-return property and operations overseas to low tax jurisdictions, or maintenance of high-return property in such jurisdictions. By hampering foreign jurisdictions' attempts to attract and retain intangible property in foreign CFCs, GILTI could make the U.S. appear, by comparison, to be a better place to keep intangibles. To the extent GILTI is effective in its aim,

217. *See* IND. CODE § 6-3-1-3.5(b)(14); *cf.* IND. CODE § 6-3-1-3.5(d)(13) (regarding life insurance companies); IND. CODE 6-3-1-3.5(e)(13) (regarding insurance companies).

the U.S., and potentially states like Indiana and Missouri, might see increased business growth, particularly in intangible-linked industries.

F. Conclusion

GILTI is a tax provision aimed at the behavioral change of companies and owners of companies, and state tax policy consistent with or contrary to GILTI can advance, or detract from, its aims. Unlike GILTI, the new TCJA provisions affecting the personal and dependency exemptions, addressed below, do not appear to be geared towards any behavior-change incentive, but instead may be aimed at the simplification of individual taxes. As we will see, simplification at the federal level may still result in complex considerations for state tax law.

XIV. PERSONAL AND DEPENDENCY EXEMPTION DEDUCTION

Unlike the newly added complexity of GILTI, the TCJA changes to the personal and dependency exemption deduction are part of a package of changes aimed at simplifying individual income taxes.[218] After reviewing what the TCJA changed and why the changes were made, we will look at how states have responded, before speculating as to how taxpayers may respond.

A. How the TCJA Modifies the Old Law and Policy Rationales

For tax years prior to 2018, individuals could exempt a calculated amount from their AGI for themselves and their dependents.[219] Collaterally, the section 151 exemption was used in calculating withholdings from employee wages, and is referenced by other sections of

218. KPMG, TAX REFORM — KPMG REP. ON NEW TAX LAW: ANALYSIS & OBSERVATIONS, 24 (2018), https:// home.kpmg.com/content/dam/kpmg/us/pdf/2018/02/tnf-new-law-book-feb6-2018.pdf
219. I.R.C. § 151 (2018).

the Code.[220]

Under the TCJA, for tax years 2018 to 2025, personal and dependency exemptions are effectively eliminated by reducing the amount of the exemption to zero dollars ($0).[221] Reducing the exemptions to zero dollars ($0), but not repealing section 151 of the Code, allows the referencing sections in the code to continue to function without needing to amend all of them.[222] Obviously this change will increase taxable income; however, this change is just one part of a package of changes that, when taken as a whole, can reduce the tax liability of an individual.[223] The Joint Committee on Taxation (the "JCT") estimated the ten year increase to revenue at $1.318 trillion on a static basis.[224] While this change will increase tax liability, most taxpayers' increase will be offset by the changes to the progressive tax rates, modifications to the standard deduction, and increases in the child tax credit.[225] While the exemption amount is the same for each person, different taxpayers will see different changes to their taxable income based on the number of dependents they have.[226] This broadening of the tax base helped to simplify the Code and pay for the other changes made by the TCJA.

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220. Larry Brant & Steven Nofziger, *Decoding the Tax Cuts and Jobs Act — Part VII: Family Matters and Major Events in the Lives of Individuals*, GARVEY SCHUBERT BARER (2018), https://www.gsblaw.c
om/larry-s-tax-law/tcja-tax-planning-families-individuals.
221. H.R. REP. NO. 115-466 (2017).
222. *Id.*
223. *Id.*
224. JOINT COMM. ON TAX'N, ESTIMATED BUDGET EFFECTS OF THE CONF. AGREEMENT FOR H.R. 1 (2017), https://www.jct.gov/publications.html?func=startdown&id=5053.
225. *Personal Exemptions and Standard Deductions and Tax Credits, oh My!*, SOL SCHWARTZ & ASSOC., P.C. (Jan. 17, 2018), https://www.ssacpa.com/personal-exemptions-standard-deductions-tax-cr
edits-oh/.
226. *Id.*

B. How States are Responding and Why

Following with the different types of conformity, we will look at how some states are responding to the modification of section 151 of the Code. What starting point a state uses for calculating state taxable income will determine what impact the elimination of the personal and dependency exemption has on its tax base.

Absent a state response, Colorado and North Dakota, which have rolling conformity and use federal taxable income as the starting point for finding state taxable income, would find an increase in their state tax base.[227] While the TCJA package does increase the standard deduction, among other base narrowing changes to individual income taxes, the net effect of the TCJA on individual income taxes is expected to broaden most state tax bases.[228] Colorado is expecting to see an increase of $200 to $300 million a year in income tax revenue.[229]

Unlike Colorado, states that use federal adjusted gross income as the starting point for state taxable income would not see a change in the state tax base.[230] However, many states that start with adjusted gross income couple eligibility of the state personal exemption with the federal personal exemption.[231] For the states that couple eligibility, the question becomes: does an exemption of zero dollars ($0) count as an exemption at all?[232] As discussed below, Missouri found that the economic reality of no federal personal exemption meant a taxpayer was not eligible for a state personal

227. FED'N OF TAX ADM'RS, STATE PERSONAL INCOME TAXES: FEDERAL STARTING POINTS (2018), https:// www.taxadmin.org/assets/docs/Research/Rates/stg_pts.pdf.
228. Jared Walczak, *Tax Reform Moves to the States*, TAX FOUND. (Jan. 31, 2018), https://taxfoundatio
n.org/state- conformity-federal-tax-reform/#6.
229. Vasilios Gerasopoulos*, The Tax Cuts and Jobs Act has been Beneficial for Colorado*, AQUILA: GROUP OF FUNDS (May 23, 2018), https://aquilafunds.com/2018/05/23/tax-cuts-jobs-act-beneficial-colo
rado/#.W4BSqM5KiM8.
230. Walczak, *supra* note 228.
231. *Id.*
232. I.R.C. § 151 (2018).

exemption.[233]

Maryland eventually took the opposite approach of Missouri. Although the Maryland Governor's proposal took the same approach as Missouri, the Maryland General Assembly did not pass those proposed reforms.[234] Instead of broadening its base and passing on the savings in the form of a rate cut, the Maryland General Assembly decided not to follow the intent of the TCJA and kept the state personal exemption.[235] Minnesota, South Carolina, and Vermont all use federal taxable income as the starting point for state taxable income.[236]

Fixed conformity states that have not updated their conformity date to include the TCJA may still use a taxpayer's federal adjusted gross income for a given year as the starting point for that year's state taxable income.[237]

Alabama, Arkansas, Massachusetts, Mississippi, New Jersey, and Pennsylvania do not use federal adjusted gross income, nor do they use federal taxable income as the starting point for state taxable income.[238] Instead, those states use state definitions for calculating state taxable income separately from the federal definitions of adjusted gross income and taxable income.[239]

Colorado, the District of Columbia, Idaho, Minnesota, New Mexico, North Dakota, South Carolina, Utah, and Vermont all couple the federal

233. H.R. 2540, 99th Gen. Assemb., 2d Reg. Sess. (Mo. 2018).
234. Walter R. Calvert & Tammara F. Langlieb, *Maryland's Response to the TCJA*, VENABLE LLP (Jun. 14, 2018), https://www.lexology.com/library/detail.aspx?g=8865b5cd-f454-486c-bada-c1089bb24b14.
235. *Id.*
236. RICHARD AUXIER & FRANK SAMMARTINO, TAX POL'Y CTR., THE TAX DEBATE MOVES TO THE STATES 8 (2018), http://www.taxpolicycenter.org/sites/default/files/publication/152171/2001677-the_tax_debate_moves_to_the_states_the_tax_cuts_and_jobs_act_creates_many_questions_for_states_that_link_to_federal_income_tax_rules.pdf.
237. Walczak, *supra* note 226.
238. AUXIER & SAMMARTINO, *supra* note 236, at 2.
239. *Id.*

standard deduction and personal exemptions.[240] These states will need to net these provisions because the TCJA changes to the standard deduction and personal exemptions both narrow and broaden the tax base, respectively.[241] The magnitude of the net impact of these provisions in any of these states will be highly dependent on the economic positions of that state's taxpayers, and may change substantially from year to year. [242]

C. Missouri Responses

For tax years prior to 2018, Missouri law granted a personal and dependency exemption deduction to all taxpayers who qualified for an exemption under IRC § 151.[243] In response to the TCJA, the Missouri General Assembly passed, and the Governor signed, HB 2540, which amended Missouri law so that taxpayers only receive a state deduction if the IRC § 151 amount is not zero.[244] HB 2540 helped to clarify RSMo. 143.151, foregoing undue and burdensome litigation over the issue. [245]

D. Indiana Responses

Because Indiana is tied to the federal definition of "dependent" under IRC § 151(c) pursuant to IC 6-3-1-3.5(a)(4), and the definition was not directly changed, Indiana determined that a response was not necessary. However, Indiana did clarify that IC 6-3-1-3.5(a)(4)(A) provided for the IRC § 151(c) definition as of January 1, 2017. For purposes of determining if an individual is a qualifying relative, the income thresholds are determined under pre-TCJA thresholds and inflation adjustments.

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240. *Id.* at 6.
241. *Id.*
242. *Id.*
243. MO. ANN. STAT. § 143.151 (West, Westlaw through 2018 Second Reg. Sess.).
244. H.B. 2540, 99th Gen. Assemb., Second Reg. Sess. (Mo. 2018).
245. *Id.*

E. Predictions of How Taxpayers Will Respond

For taxpayers in Colorado and North Dakota, more tax planning will be needed because those states are rolling conformity and use federal taxable income as their starting point for state taxable income.[246] Taxpayers who have more dependents but cannot take advantage of the childtax credit will be saddled with much higher liabilities. Because of this expected increase, taxpayers may move income earning dependents off of their returns and have them file a separate return. Shifting part of the household's income onto a separate return may double the standard deduction for the households that can take advantage of it.

Because Alabama, Arkansas, Massachusetts, Mississippi, New Jersey, and Pennsylvania use state definitions instead of federal definitions, taxpayers in those states will not need to change their current tax planning strategies.[247] Because Maryland kept its personal exemption, taxpayers there may see lower tax liabilities without any tax planning on their part.[248]

F. Conclusion

The elimination of the personal and dependency exemptions was a needed change to simplify individual taxes and balance the cost of other changes in the TCJA. Prior to 2025 Congress will need to extend the elimination or find other pay-fors to reinstate the personal and dependency exemptions. While some states are not impacted, those that are will need to reevaluate what to do come 2025-unless they took an approach like Missouri did with automatic triggers. In contrast to the base broadening effect of eliminating personal and dependency exemptions, the TCJA allows some taxpayers to deduct up to 20% of certain domestic Qualified

246. FED'N OF TAX ADM'RS, *supra* note 227.
247. AUXIER & SAMMARTINO, supra note 236, at 2.
248. Calvert & Langlieb, *supra* note 234.

Business Income from partnerships, S-Corps, and sole proprietorships.[249]

XV. QUALIFIED BUSINESS INCOME DEDUCTION

In the same way the elimination of the Personal and Dependency Exemptions was meant to simplify individual income taxes, the Qualified Business Income Deduction was meant to simplify business income taxes.[250] After reviewing what the TCJA changed, and why the changes were made, we will look at how states have responded, before speculating as to how taxpayers may respond.

A. How the TCJA Modifies the Old Law and Policy Rationales

One of the biggest policy goals of the TCJA was to lower America's corporate income tax rate to be closer to the corporate tax rates of other OECD countries.[251] Under the TCJA, there is now a sixteen percent (16%) difference between the statutory corporate and individual income tax rates.[252] The difference becomes even greater when looking at the combined federal and state rates.[253] A difference of this size creates a huge tax incentive for businesses to adopt a corporate tax structure, and leads to capital being tied up at the corporate level that would otherwise have been reinvested.

To mitigate the difference in the corporate and individual tax rates, the TCJA creates a deduction for qualified business income.[254] This deduction is available to taxpayers that are taxed as partnerships, S-corps, or sole

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249. I.R.C. § 199A (2018).
250. KPMG, *supra* note 218, at 58.
251. Kyle Pomerleau, *The United States' Corporate Income Tax Rate is Now More in Line with Those Levied by Other Major Nations*, TAX FOUND. (Feb. 12, 2018) [hereinafter *Corp. Tax Rate Comparison*], https://taxfoundation.org/us-corporate-income-tax-more-competitive/.
252. Tax Cuts & Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of 26 U.S.C.).
253. *Corp. Tax Rate Comparison*, *supra* note 249.
254. I.R.C. § 199A (2018).

proprietorships.[255] An individual taxpayer may deduct twenty percent (20%) of certain domestic qualified business income earned from a qualifying entity.[256] The 20% deduction is limited to the greater of (1) fifty percent (50%) of W-2 wages earned by the taxpayer taking the deduction, or (2) twenty-five percent (25%) of W-2 wages earned by the taxpayer plus two-and-a-half (2.5%) percent of unadjusted basis of certain property.[257] The limitation on the deduction is phased-in starting at $157,000 (double for filling jointly).[258] This deduction for qualified business income is expected to be determined after calculating adjusted gross income.[259] While not the same as the qualified business income deduction, there is a similar deduction available to agricultural and horticultural co-ops.[260]

B. How States are Responding and Why

Because the 20% deduction does not apply to adjusted gross income, most states will not see a direct impact to state tax revenue.[261] Because Colorado and North Dakota are both rolling conformity states and use federal taxable income, the 20% deduction will flow through, directly narrowing their respective tax bases.[262] Idaho, Minnesota, Oregon, and South Carolina also use federal taxable income, and those states will see the impact of the 20% deduction if they update their conformity dates to

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255. *Id.*; *See also* CORDASCO & CO. P.C., TAX CUT & JOBS ACT 2017: L., EXPLANATION & ANALYSIS, DETAILED 55 (2017), https://www.cspcpa.com/wp-content/uploads/2010/09/Tax-Cuts-and-Jobs-Act-20
17.pdf.
256. 26 U.S.C. § 199A(a) (2018); *see also* CORDASCO & CO., *supra* note 255.
257. 26 U.S.C. § 199A(b)(2) (2018); *see also* CORDASCO & CO., *supra* note 255.
258. 26 U.S.C. § 199A(b)(3)(A) (2018); *see also* CORDASCO & CO., *supra* note 255, at 56.
259. I.R.S. Form 1040 (2018); *see also* Tax Cuts & Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of I.R.C.); *see also* CORDASCO & CO., *supra* note 255.
260. 26 U.S.C. § 199A(g) (2018); *see also* CORDASCO & CO., *supra* note 255.
261. Auxier & Sammartino, *supra* note 236, at 8.
262. Walczak, *supra* note 228.

incorporate the TCJA.[263]

C. Missouri Responses

Because the deduction is not a part of a taxpayer's adjusted gross income it will have no direct impact on Missouri taxpayers.[264] There is no direct impact on Missouri tax returns because Missouri's returns look at the taxpayer's federal adjusted gross income.[265] There is an indirect impact to Missouri taxpayers via Missouri's Federal Income Tax deduction.[266] To the extent that section 199A of the Code lowers the taxpayer's federal tax liability, the Missouri tax liability could increase by a proportional amount. The increase in a taxpayer's Missouri tax liability will only affect taxpayers with less than five thousand dollars ($5,000) in federal tax liability.[267] Further, the increase in a taxpayer's Missouri tax liability will be diluted due to the new percentage limitations the Missouri General Assembly passed in 2018.[268]

D. Indiana Responses

For individuals, the IRC § 199A deduction is not part of federal adjusted gross income. Accordingly, absent any other action, the provision would not have affected Indiana.[269] Indiana did not react for individuals.

For estates and trusts, these entities start with federal taxable income for

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263. *Id.*
264. I.R.S. Form 1040 (2018); 26 U.S.C. § 62(a) (2017); *see also* CORDASCO & CO., *supra* note 253.
265. MO. ANN. STAT. § 143.121(1) (West, Westlaw through 2018 2d Reg. Sess.).
266. MO. ANN. STAT. § 143.171 (West, Westlaw through 2018 2d Reg. Sess.) (taking effect on January 1, 2019).
267. MO. ANN. STAT. § 143.171(1) – (2) (West, Westlaw through 2018 2d Reg. Sess.) (taking effect on January 1, 2019).
268. MO. ANN. STAT. § 143.171 (West, Westlaw through 2018 2d Reg. Sess.) (taking effect on January 1, 2019).
269. *See* IND. CODE 6-3-1-3.5(a) (2018) (providing that adjusted gross income is the amount as defined under IRC § 62).

determining Indiana adjusted gross income.[270] Accordingly, absent any action from Indiana beyond updating the Internal Revenue Code conformity date, the §199A deduction would have been allowed. Because the effect would have been to permit a preferential rate to estates and trusts otherwise unavailable to individuals, Indiana decoupled from the deduction.

E. Predictions of How Taxpayers Will Respond

For many small businesses that are currently taxed as a C corporations, the 20% deduction will be a strong factor pushing for S corporation status, or even reorganization as a qualifying pass-through. In contrast, small businesses that do not qualify for the section 199A deduction, or who do not receive the full benefit due to the limitations, will have strong motivation from the new lower corporate tax rates to reorganize as well. While taxation is not a dispositive factor in entity selection, it does carry substantial weight, all the more so for narrow margin industries. Additionally, businesses may reorganize by spinning off non-qualifying parts of the business. In Missouri, and similar states, taxpayers will be faced with added complexity in needing to prepare multiple returns to see if they benefit from taking the deduction or not.

F. Summary

The 20% deduction for qualified business income was a needed change to balance the distortion in the tax rates between businesses and individuals. The added complexity of the new deduction will be a new cost to some new businesses and existing businesses alike; however, such a cost is balanced, and overcome, by the saving gained via other provisions of the TCJA. Analysis of any provision of the TCJA can only be done while evaluating the impact of the TCJA as a whole.

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270. IND. CODE 6-3-1-3.5(f)(11) (2018).

CONCLUSION

The provisions of the TCJA analyzed above can be centered around three themes: alterations to the taxing framework affecting domestic business; the transition to a territorial system in the international arena; and changes to the taxation of individuals.

Regarding domestic businesses, the TCJA modified § 168(k) bonus depreciation and § 179 asset expensing, including the allowance of 100% first-year depreciation in certain circumstances. Missouri has passively accepted the TCJA's changes to depreciation rules, while Indiana's statutory schema is partially coupled and partially decoupled from these TCJA provisions. The TCJA also limited the deductibility of business interest; Missouri couples to this limitation while Indiana has decoupled from it. The TCJA newly allows pass-through entities a qualified business income deduction of 20% of a certain measure of business income. Although Missouri has not actively decoupled from the qualified business income deduction, it will not flow through to Missouri's tax base, although it will indirectly impact the federal income tax deduction available to Missouri taxpayers. Because individual Indiana taxpayers will not receive the qualified business income deduction at the state level, Indiana actively decoupled from that deduction for estates and trusts to avoid preferential treatment of such entities over individuals.

In transitioning the U.S. international tax structure to a territorial system, the TCJA applies a 'stick,' the Transition Tax, against multinational corporations who kept their earnings in companies they owned overseas. Moreover, once in a territorial system, the TCJA's GILTI provision is designed to defend against foreign jurisdictions attracting high return-producing intangibles with comparatively low tax rates. Both Missouri and Indiana offer a dividends received deduction that may increase as a result of the Transition Tax and/or GILTI, at least for C-corporations under certain circumstances.

For individuals, the TCJA reduced the personal and dependency exemptions to $0 (although increasing the child tax credit and standard deduction). Missouri's General Assembly responded by passing legislation clarifying its conformity with this provision of the TCJA, and Indiana determined that a response was unnecessary. Further, individuals should benefit from the TCJA's alterations to 529 Plans, expanding the definition of qualified education expenses to include K-12 expenses, as well as providing favorable treatment to rollovers from 529 Plans to ABLE accounts. Both Missouri and Indiana enacted legislation pertaining to their state 529 savings programs following the TCJA's changes to IRC § 529.

To summarize, the TCJA is a complicated reform fitted for a complicated area of law and policy. As with all other complex areas of law, states – including Missouri and Indiana – will need to carefully evaluate the impact of new changes and be willing to adjust as necessary for the good of their citizens.