

State tax implications: 2018 federal tax reform guidance, Section 385 developments

January 7, 2019

In brief

During 2018, Treasury and the IRS released thousands of pages of proposed regulations and other guidance concerning the 2017 federal tax reform legislation. Proposed regulations address the Section 965 toll charge, GILTI, Section 163(j) interest expense deduction limitation, full expensing under Section 168(k), Section 199A, Section 956, foreign tax credits, and BEAT. The IRS also issued a number of Notices in 2018, including guidance on forthcoming regulations on previously taxed earnings and profits accounts. In early 2019, it is anticipated that proposed regulations will be released under Sections 172 and 250, just to name a few.

In addition to tax reform developments, taxpayers need to consider the impact of the Section 385 regulations, where the only change to date was to remove the documentation rules while not removing or modifying the remaining portions of the 385 regulations.

The release of a significant volume of proposed guidance in a relatively short period of time creates challenges for businesses and state tax practitioners regarding the impact of the new guidance on state tax matters. This Insight does not discuss all state tax consequences of federal tax reform or the Section 385 regulations, but rather highlights some of the major considerations in evaluating the impact of certain federal provisions. This Insight notes the need for separate state calculations for many federal tax reform matters.

Observation: Taxpayers should continue to monitor the many state tax issues not addressed in the proposed regulations that require state-specific analysis and guidance. A sample of such issues is provided in this Insight as well.

In detail

IRC Section 965

Released on August 1, 2018, proposed Section 965 regulations generally follow guidance provided in previously

issued Notices. The proposed regulations address, among other issues, E&P and basis adjustments, determining the allowable deduction, aggregate foreign cash position, foreign tax credits, and rules for calculating

the 965 toll charge for both affiliated and consolidated groups. Click [here](#) for our Insight on the proposed regulations.

The proposed rules around consolidation could have significant impact for state taxpayers. For example, Prop. Treas. Reg. Sec. 1.965-8 details the different toll charge inclusion amount for affiliated corporations vs. corporations in a federal consolidated group. State conformity to Section 965, the reporting methodology of a state (e.g., separate, combined, consolidated), and whether a state reporting group is the same as federal may contribute to considerable differences between a federal and state calculation of a taxpayer's Section 965 toll charge. Multiple independent state calculations may be required to comply with different state reporting requirements.

The proposed regulations highlight other state tax considerations, including:

- the potential for different federal and state E&P and basis measurements in 2017 and beyond
- whether states have the statutory authority to deny the Section 965(c) deduction.

Observation: Although 2017 tax year returns have been filed by most taxpayers, Section 965 remains an ongoing concern because 2017 federal and state tax returns may require amendments. In addition, the toll charge may be reportable in a taxpayer's 2018 tax year depending on the tax year-end of a taxpayer's controlled foreign corporation (CFC).

Other state tax issues regarding Section 965 include:

- whether states will conform to Section 965 for the 2018 tax year
- whether states will apply their dividends received deduction to Section 965 income

- whether Section 965 income is included in the apportionment factor
- whether states will require an expense disallowance related to Section 965 income
- how states that do not conform to Section 965 will treat foreign cash dividends that are excluded from gross income for federal purposes.

GILTI

Released on September 15, 2018, proposed regulations provide guidance for determining a US shareholder's GILTI inclusion, including rules for determining GILTI inclusion for US Shareholders that file on a federal consolidated return basis and a rule for adjusting the basis of the CFC stock based on the tested losses generated by the CFC. Click [here](#) for our Insight on the proposed regulations.

One major state implication of the GILTI proposed regulations derives from Prop. Reg. Sec. 1.1502-51 regarding the GILTI calculation for taxpayers that file a federal consolidated return. The proposed regulation provides that in order to determine a consolidated group member's GILTI inclusion amount, the pro rata shares of tested loss, qualified business asset investment (QBAI), tested interest expense, and tested interest income of each member are aggregated and allocated to certain members of the group measured by tested income.

Taxpayers will need to determine whether a particular state follows the federal consolidated return regulations overall and specifically whether it adopts the new Sec. 1502-51 proposed regulation. If the state does not adopt that rule, the calculation of the GILTI amount reported to that state could vary greatly from the

federal calculation. Accordingly, taxpayers may have to calculate multiple variations of GILTI to satisfy different state reporting methods.

Similarly, taxpayers in states that would not follow the proposed regulation may have different state basis calculations than they have for federal purposes. This provides another reason why taxpayers need a process in place to manage multiple calculations that differ from federal amounts.

Observation: Open questions remain regarding the calculation of the Section 250 deduction, including how the deduction is calculated as part of a consolidated return and how to apply the Section 250 limitation for taxpayers with NOL carryforwards. Proposed federal regulations regarding Section 250 are expected in early 2019.

Other state tax issues regarding GILTI include:

- whether states will conform to GILTI for the 2018 and future tax years
- whether states will treat GILTI as a dividend and, if so, whether the dividends received deduction applies
- whether states will allow GILTI to be included in the apportionment factor
- whether states will require an expense disallowance related to GILTI
- whether there are any constitutional concerns with regards to a state's ability to tax GILTI
- how states that conform to GILTI will treat distributions of E&P not

previously taxed as GILTI, Subpart F, etc.

- how states that don't conform to GILTI will treat foreign cash dividends that are excluded from gross income for federal purposes.

Section 163(j) interest expense limitation

On November 26, 2018, Treasury released proposed regulations under Section 163(j). Section 163(j), as modified for tax years beginning after December 31, 2017, generally limits business interest expense deductions. The proposed regulations provide guidance relating to the mechanics of determining the interest expense limitation, and clarify how Section 163(j) applies to taxpayers filing as part of a federal consolidated group, in addition RICs, REITs, partnerships, CFCs, and other foreign corporations. Click [here](#) for our Insight on the proposed regulations.

Observation: A significant issue for state taxpayers is how the limitation is calculated. The proposed regulations rely upon the authority granted in the consolidated return regulations to support the calculation of a single 163(j) limitation for taxpayers that file as part of a federal consolidated group. For states that have not fully adopted the consolidated return regulations as part of the state filing rules, the calculation of the federal starting point for state purposes presumably would be determined on a separate company basis and, as such, the taxpayer or combined group could have a different 163(j) limitation for state purposes than they have for federal purposes.

Other state tax considerations following the proposed regulations include:

- **Potential for more transactions to qualify as related-party interest expense.** The proposed

regulations broaden the definition of interest expense subject to the limitation. States with related-party interest addbacks may follow the broadening of the definition and then apply the new definition to their addback rules.

- **Different state calculations for Adjusted Taxable Income (ATI).** The proposed regulations indicate that intercompany obligations between consolidated group members are disregarded in determining business interest expense and interest income, and in determining the consolidated group's ATI. Similarly, intercompany items and corresponding items, as defined in the consolidated return regulations that offset in amount also are disregarded. Therefore, in states that have not fully adopted the consolidated return regulations as part of the state filing rules, business interest expense, business interest income, and ATI may be different than the federal amounts.
- **How the limitation applies in states with a related-party interest addback.** It remains unclear how the limitation will be allocated between intercompany and third-party interest. At least two states, Alabama and New Jersey, have indicated that the limitation generally is allocated on a pro-rata basis.
- **Disallowed interest carryover and Sections 381/382.** The proposed regulations would allow for carryover to successors in certain merger or acquisition transactions, subject to Sections 381 and 382, and would recognize the intersection of the separate

return limitation year (SRLY) rules and Section 382 rules.

- **Relationship with NOLs.** A state interest expense limitation different than federal may result in a taxpayer moving from a loss year into an income position and therefore require the application of NOLs.
- **Allocation of 163(j) limitation and interest expense carryovers to consolidated group members.** The proposed regulations provide rules on how consolidated group members determine their portion of the 163(j) limitation and disallowed interest expense. Therefore, in states that have not fully adopted the consolidated return regulations as part of the state filing rules, application of the 163(j) limitation and utilization of interest expense carryovers may differ from federal.
- **CFC group election.** The proposed regulations provide that 163(j) applies to certain CFCs. An irrevocable CFC group election for two or more CFCs can be made which enables the CFC group to calculate net business interest expenses on a group basis, among other ramifications. The election can be made if at least 80% of the value of the stock of each CFC is owned by a single US shareholder or certain related U.S. shareholders. For purposes of this test, consolidated group members are treated as a single person. Therefore, in states that have not fully adopted the consolidated return regulations as part of the state filing rules, the CFC group election may be different or may not apply at all.
- **Flow-through treatment.** The proposed regulations suggest an

entity-level approach to calculate the limitation. This may not have an impact in states that impose entity-level taxes, but flow-throughs in other states may have different limitation calculations if partners cannot determine their limitations measured by attributes of pass-through entities. Flow-throughs should consider several other aspects of the limitation, including excess taxable income, excess business interest income, and excess business interest expense.

Section 385

Although not a provision of federal tax reform legislation, Section 385 considerations remain relevant to the computation of interest expense, which impact the 163(j) interest expense limitation.

Treasury originally released proposed Section 385 regulations on April 4, 2016, and then final regulations on October 21, 2016, with documentation rules applying to debt issued on or after January 1, 2018. On July 28, 2017, the IRS issued Notice 2017-36, which delayed the application of documentation rules to debt issued on or after January 1, 2019. New proposed regulations issued on September 21, 2018, withdrew Treas. Reg. sec. 1.385-2. Click [here](#) for our Insight on the proposed regulations and click [here](#) for our Insight on the state tax implications of the Section 385 regulations.

It should be noted that that Treas. Reg. sec. 1.385-3 is still in effect and has been modified to reflect the removal of Reg. sec. 1.385-2. Reg. sec. 1.385-3 generally treats debt as stock if it is issued by a corporation to a member of the corporation's expanded group (1) in a distribution in which a subsidiary distributes a note to its parent; (2) in exchange for expanded group stock (e.g., in a

Section 304 transaction) other than in an exempt exchange; or (3) as consideration in an asset reorganization (e.g., in a Section 368(a)(1)(D) reorganization) (the 'General Rule'). The regulation also treats as stock any debt instrument issued to fund any of the three transactions targeted by the General Rule.

Observation: Although the documentation rule is proposed to be revoked, taxpayers should consider the impact of Reg. sec. 1.385-3, especially in light of the fact that 1.385-4T applies the one-corporation exception on a consolidated return basis. Therefore, similar to the discussion above, taxpayers will need to consider what complications may arise in states that apply this rule in a non-consolidated context.

Section 172 NOL limitation

Taxpayers should monitor federal regulatory developments regarding Section 172 since proposed regulations have not yet been issued, although they are expected in early 2019.

Federal tax reform provides that, effective generally for losses arising in tax years beginning after 2017, NOLs generally are limited to 80% of income. Additionally, for NOL losses arising in taxable years ending after 2017, there is no NOL carryback and there is an indefinite carryforward. State tax considerations include conformity to the new Section 172 provision. State conformity may be challenging to determine as many states have state-specific NOLs similar to Section 172, but may not directly adopt Section 172. Additionally, complexities may arise (similar to those noted above around Section 965, GILTI, and Section 163(j)) if the NOL limitation is computed on a consolidated basis.

Previously taxed earnings and profits

On December 14, 2018, the IRS released Notice 2019-01, which outlines previously taxed earnings and profits accounts (PTEP) regulations that Treasury intends to release in light of the enactment of federal tax reform. PTEP refers to E&P of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a US shareholder under Section 951(a) or under Section 1248(a). The Notice also provides guidance as to how GILTI inclusions in excess of current year PTI can create deficits in Section 959(c)(3) E&P. Click [here](#) for our Insight on the Notice.

Observation: The Notice highlights the complexities around calculating E&P changes as a result of Section 965 and GILTI. Taxpayers in states that do not conform to federal tax reform provisions could have entities with different basis and/or E&P amounts for state purposes than they do for federal purposes. These differences may result in state tax, for example, when a CFC makes a distribution because it is considered PTEP federally, but would be considered E&P for state.

Other proposed regulations

Proposed regulations have been issued regarding the following tax reform areas. Links to our Insights are provided. State conformity to the following areas may impact state tax liability and, therefore, state tax practitioners should monitor developments in these areas.

- **Full expensing under Section 168(k).** Released on August 3, 2018, proposed regulations provide guidance around the application of bonus depreciation following tax reform. Click [here](#) for our Insight.

- **Section 199A.** Released on August 16, 2018, proposed regulations address the Section 199A deduction for up to 20% of 'combined qualified business income' from partnerships, S corporations, sole proprietorships, trusts, and estates. Click [here](#) for our Insight.
- **Section 956.** Released on October 31, 2018, proposed regulations would exclude corporate US shareholders from the application of Section 956 to the extent the US shareholder would be allowed a deduction under Section 245A if it had received a distribution from the CFC in an amount equal to the amount otherwise determined under Section 956. Click [here](#) for our Insight.
- **Foreign tax credits.** Released on November 28, 2018, proposed regulations provide needed guidance related to the mechanics of determining the FTC limitation under Section 904 (including the allocation and apportionment of expenses), the scope of the new foreign branch basket, and the extent of deemed-paid FTCs with respect to subpart F and global intangible low-taxed income (GILTI) inclusions. Click [here](#) for our Insight.
- **Opportunity Zones.** Although the IRS has recently released regulations and a [frequently asked questions page](#), there still exists a fair amount of uncertainty and opportunity around state tax implications, including state conformity to the federal provisions, differences between corporate and individual state tax treatment, and the availability of additional state and local economic incentives.
- **BEAT.** States generally do not adopt non-income tax provisions of the Internal Revenue Code. Nevertheless, state laws should be monitored to determine whether Section 59A has been adopted by a state. BEAT proposed regulations were released on December 13, 2018. Click [here](#) for our Insight.

The takeaway

The disconnect between state and federal treatment of tax reform provisions may be due to states not conforming to the 2017 legislation or because states do not follow the consolidated or other federal treatment unique to the federal calculation. As a result of these differences, state taxpayers may have different tax liability, E&P, basis, and other matters for state purposes than they do for federal purposes. These differences highlight the need for state tax professionals to work closely with their international and federal counterparts to establish procedures for making the numerous state-specific calculations needed to comply with the many different reporting requirements across the states.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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