WHAT EVERY GENERAL PRACTITIONER SHOULD KNOW ABOUT THE NEW TAX LAWS

PROGRAM MATERIALS
December 13, 2018
WHAT EVERY GENERAL PRACTITIONER SHOULD KNOW ABOUT THE NEW TAX LAWS

6 CLE Hours

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**SOLACE** is a program of the State Bar of Georgia designed to assist those in the legal community who have experienced some significant, potentially life-changing event in their lives. SOLACE is voluntary, simple and straightforward. SOLACE does not solicit monetary contributions but accepts assistance or donations in kind.

**Contact SOLACE@gabar.org for help.**
The purpose of the SOLACE program is to allow the legal community to provide help in meaningful and compassionate ways to judges, lawyers, court personnel, paralegals, legal secretaries and their families who experience loss of life or other catastrophic illness, sickness or injury.

TESTIMONIALS

In each of the Georgia SOLACE requests made to date, Bar members have graciously stepped up and used their resources to help find solutions for those in need.

A solo practitioner’s quadriplegic wife needed rehabilitation, and members of the Bar helped navigate discussions with their insurance company to obtain the rehabilitation she required.

A Louisiana lawyer was in need of a CPAP machine, but didn’t have insurance or the means to purchase one. Multiple members offered to help.

A Bar member was dealing with a serious illness and in the midst of brain surgery, her mortgage company scheduled a foreclosure on her home. Several members of the Bar were able to negotiate with the mortgage company and avoided the pending foreclosure.

Working with the South Carolina Bar, a former paralegal’s son was flown from Cyprus to Atlanta (and then to South Carolina) for cancer treatment. Members of the Georgia and South Carolina bars worked together to get Gabriel and his family home from their long-term mission work.

Contact SOLACE@gabar.org for help.
Dear ICLE Seminar Attendee,

Thank you for attending this seminar. We are grateful to the Chairperson(s) for organizing this program. Also, we would like to thank the volunteer speakers. Without the untiring dedication and efforts of the Chairperson(s) and speakers, this seminar would not have been possible. Their names are listed on the AGENDA page(s) of this book, and their contributions to the success of this seminar are immeasurable.

We would be remiss if we did not extend a special thanks to each of you who are attending this seminar and for whom the program was planned. All of us at ICLE hope your attendance will be beneficial as well as enjoyable. We think that these program materials will provide a great initial resource and reference for you.

If you discover any substantial errors within this volume, please do not hesitate to inform us. Should you have a different legal interpretation/opinion from the speaker’s, the appropriate way to address this is by contacting him/her directly.

Your comments and suggestions are always welcome.

Sincerely,
Your ICLE Staff

*Jeffrey R. Davis*
Executive Director, State Bar of Georgia

*Tangela S. King*
Director, ICLE

*Rebecca A. Hall*
Associate Director, ICLE
AGENDA

PRESIDING: Vivian D. Hoard, Program Co-Chair, Taylor English Duma LLP, Atlanta
          David F. Golden, Program Co-Chair, Troutman Sanders LLP, Atlanta

7:30    REGISTRATION AND CONTINENTAL BREAKFAST

8:00    WELCOME AND PROGRAM OVERVIEW
        Vivian D. Hoard

8:15    DEDUCTIONS: MUCH HAS CHANGED
        R. Brian Gardner, III, Taylor English Duma LLP, Atlanta

9:15    CHOICE OF ENTITY DETERMINATIONS POST-TAX REFORM
        Zachary D. “Zach” Wilson, Arnall Golden Gregory LLP, Atlanta
        Matthew R. Peurach, Morris Manning & Martin LLP, Atlanta

10:45   BREAK

11:00   AN ALL NEW TAX INCENTIVE: OPPORTUNITY ZONES
        Timothy S. Pollock, Morris Manning & Martin LLP, Atlanta

12:00   LUNCH (Included in registration fee.)

12:45   CAN I REALLY DEDUCT 20% OF MY INCOME UNDER 199A?
        Robert A. Beard, King & Spalding LLP, Atlanta
        Julian A. Fortuna, Taylor English Duma LLP, Atlanta

2:15    BREAK

2:30    THE NEW TAX LAWS’ IMPACT ON STATE TAXES
        W. Scott Wright, Eversheds Sutherland (US) LLP, Atlanta
        Alla Raykin, Eversheds Sutherland (US) LLP, Atlanta

3:30    ADJOURN
DEDUCTIONS: MUCH HAS CHANGED
R. Brian Gardner, III, Taylor English Duma LLP, Atlanta
DEDUCTIONS: MUCH HAS CHANGED
State Bar of Georgia, Atlanta, Georgia

Presented By:

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**New Tax Rates**

### Individual Taxpayer – Single Filing Status

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<thead>
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### Head of Household

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**Taxpayers in the $200,000 to $500,000 income range may be under withheld for 2018 because a portion of their income was bumped into a higher rate bracket. For example, a single individual last year paid 33% on income between $191,650 and $416,700. This year that person will pay 35% on income between $200,000 and $500,000.**

**Taxpayers with large SALT deductions may also be under withheld because of the $10,000 cap.**
I. Standard Deduction

<table>
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<tr>
<th>Filing Status</th>
<th>Prior to TCJA</th>
<th>After TCJA</th>
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<tbody>
<tr>
<td>Single</td>
<td>$6,350</td>
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<tr>
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<td>$24,000</td>
</tr>
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<td>Head of Household</td>
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<td>$12,000</td>
</tr>
<tr>
<td>Married Filing Separately</td>
<td>$9,350</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

a. Itemized deductions are irrelevant unless they exceed the standard deduction.

i. This means that married taxpayers filing jointly will need to have more than $24,000 in Schedule A itemized deductions such as the State and Local income tax deduction (limited to $10,000), student loan interest deduction (limited to $2,500), mortgage interest deduction, charitable deductions and medical and dental expense deductions (in excess of 7.5% of AGI).

b. Some studies estimate that only 5-10% of the population will use itemized deductions.

c. Planning Tip: One idea is to batch all of your charitable deductions into one year, so that you can capitalize on your itemized deductions in that year and rely on the standard deduction in other years.

II. Surviving Deductions

a. TCJA increased the limit for charitable contributions from 50% of AGI to 60% of AGI.

i. Taxpayers should consider bunching charitable deductions and itemizing their deductions in those years.

b. Student Loan Interest – Limited to $2,500. Subject to modified adjusted gross income phaseout.
c. Educator Expenses - $250 above-the-line deduction for educators spending on books, supplies, etc.

III. Modified Deductions

a. Home Mortgage Interest – Taxpayers may only deduct interest on acquisition indebtedness under the TCJA i.e. mortgage used to buy, build or improve their home up to $750,000.

   i. For mortgages taken out before December 15, 2017, the limit is $1 million for taxpayer married filing jointly.

b. SALT Deductions - Deductions for State and Local sales, income and property taxes together may not exceed $10,000.

c. Medical and Dental Expenses – Increased ”floor” for medical and dental expenses to 7.5% of AGI.

IV. Eliminated Deductions


b. Casualty and Theft Losses – TCJA repealed the deduction for casualty and theft losses except for those losses attributable to a federal disaster declared by the President.

c. Settlements Paid in Connection with Sexual Harassment or Sexual Abuse Subject to NDA’s: No deduction for any settlement, payout, or attorney’s fees if they are subject to a nondisclosure agreement. IRC § 162(q).

d. Unreimbursed Employee Business Expenses – TCJA eliminated all miscellaneous itemized deductions that are subject to the 2% of AGI floor.

e. Common Unreimbursed Expenses Previously Deductible by Employees:

   (1) casualty and theft losses from property used in performing services as an employee,
(2) business bad debt of an employee,
(3) business liability insurance premiums,
(4) damages paid to a former employer for breach of an employment contract,
(5) depreciation on a computer a employee’s employer requires her to use in her work,
(6) dues to a chamber of commerce if membership helps the employee perform their job,
(7) dues to professional societies,
(8) educator expenses,
(9) home office or part of a employee’s home used regularly and exclusively in their work,
(10) job search expenses in the employee’s present occupation,
(11) legal fees related to the employee’s job,
(12) licenses and regulatory fees,
(13) malpractice insurance premiums,
(14) medical examinations required by an employer,
(15) occupational taxes,
(16) passport fees for a business trip,
(17) research expenses of a college professor, (18) subscriptions to professional journals and trade magazines related to the employee’s work,
(19) tools and supplies used in the employee’s work,
(20) costs for travel, transportation, meals, entertainment, gifts, and local lodging related to the employee’s work,
(21) union dues and expenses,
(22) work clothes and uniforms if required and not suitable for everyday use; and
(23) work-related education.

V. Be Wary of “Solutions” for Eliminated Deductions
a. But my employees really want those deductions. Should we make them independent contractors?

i. Don’t forget the 20-factor test.

ii. Three Main Categories:

1. **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job?

2. **Financial:** Are the business aspects of the worker’s job controlled by the payer? (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)

3. **Type of Relationship:** Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

iii. **Access to business deductions is not part of the test.**

b. How about making them statutory employees?

i. **Statutory employees:** If someone who works for you isn't an employee under the common law rules discussed earlier, don't withhold federal income tax from his or her pay, unless backup withholding applies.

1. Although statutory employees may not be common law employees, they’re considered employees by statute for social security, Medicare, and FUTA tax purposes under certain conditions.

2. Statutory employees receive a Form W-2 that will have box 13, Statutory Employee, checked.

3. Statutory employee reports income and expenses on Schedule C.

ii. **Who is a Statutory Employee?**
1. An agent (or commission) driver who delivers food, beverages (other than milk), laundry, or dry cleaning for someone else.

2. A full-time life insurance salesperson who sells primarily for one company.

3. A homeworker who works by guidelines of the person for whom the work is done, with materials furnished by and returned to that person or to someone that person designates.

4. A traveling or city salesperson (other than an agent-driver or commission-driver) who works full time (except for sideline sales activities) for one firm or person getting orders from customers. The orders must be for merchandise for resale or supplies for use in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging. See IRC § 3121(d)(3).

   a. Worker must exhibit more of the traits of an independent contractor than of a common law employee. See Hathaway v. Commissioner, T.C. Memo. 1996-389.

   b. Relevant Factors:

   i. TP paid on a commission basis

   ii. TP paid his own business expenses

   iii. TP paid assistants

   iv. TP paid the cost of maintaining a business headquarters

   v. TP guaranteed customer credit in some situations.
c. Consequences of Misclassifying Employees?

i. If the misclassification was unintentional, the employer could face the following penalties:

1. $50 for each W-2 the employer failed to file

2. 1.5% of the wages, plus 40% of the FICA taxes that were not withheld from the employee, plus 100% of the matching FICA taxes the employer should have paid. IRC § 3509.

3. Failure to Pay penalties.

ii. If the misclassification is intentional, employer could be subject to penalties that include 20% of all of the wages paid, plus 100% of the employee and employer’s share of FICA taxes.

iii. Not to mention trouble with the Departments of Labor

VI. Business Deductions

a. Business Entertainment – TCJA eliminates 50% deduction for entertainment, amusement or recreation directly related to the business. See IRS Notice 2018-76.

i. “Entertainment” means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation, and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term “entertainment” may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or the customer's family.
ii. Eliminates deductions for sports tickets, country clubs, concert tickets, etc. Treas. Reg. § 1.274-2(b)(1)(i)

iii. Entertainment does not include:

1. Dinner money provided by an employer to an employee working overtime,

2. Hotel room maintained by an employer for lodging of employees while in business travel status, or

3. A vehicle used in the active conduct of a trade or business even though also used for routine personal purposes.

b. Business Meals

i. IRS Notice 2018-76: Provides limited guidance and announces regulations are coming to address deductibility of business meals.

ii. § 274(k) provides that taxpayers may deduct 50% of an otherwise allowable business meal expense if:

1. the expense is an ordinary and necessary expense paid or incurred during the tax year in carrying on a trade or business;

2. the expense isn't lavish or extravagant under the circumstances;

3. the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;

4. the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and

5. if food and beverages are provided during or at an entertainment activity, then they're bought separately from the entertainment, or their cost is stated
separately from the cost of the entertainment on one or more bills, invoices, or receipts.

a. The food and beverage charge can’t be inflated to circumvent the entertainment disallowance rule.

c. Examples from IRS Notice 2018-76

i. Example 1

1. Taxpayer A invites B, a business contact, to a baseball game. A purchases tickets for A and B to attend the game. While at the game, A buys hot dogs and drinks for A and B.

2. The baseball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by A. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game.

ii. Example 2

1. Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages.

2. The basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the...
food and beverages also is an entertainment expense that is subject to the § 274(a)(1) disallowance. Therefore, C may not deduct any of the expenses associated with the basketball game.

iii. Example 3

1. Assume the same facts as in Example 2, except that the invoice for the basketball game tickets separately states the cost of the food and beverages.

2. As in Example 2, the basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

d. Employee Meals on Company Premises

i. Employee meals on company premises subject to two sets of rules:

1. For amounts paid or incurred after 2017 and before 2026, these meals are exempt from the general disallowance of deductions for entertainment.

   a. However, the meals are still subject to the 50% limitation for meal expenses;

2. For amounts paid or incurred after 2025, no deduction will be allowed for: any expense for the operation of an employer-operated eating facility, any expense for food or beverages associated with an employer-operated eating facility; or any expense for meals on employer’s premises.
e. Net Operating Losses

i. Before the TCJA

1. NOL could be carried back two years and forward up to 20 years.

2. Special extended carryback periods were allowed for NOLs attributable to certain specified liability losses and certain casualty and disaster losses.

ii. After the TCJA

1. NOL deduction for tax year is equal to the lesser of
   a. the aggregate of the NOL carryovers to such year, plus the NOL carry-backs to such year, or
   b. 80% of taxable income (determined without regard to the deduction). IRC § 172(a)).

2. Generally, NOLs can no longer be carried back but are allowed to be carried forward indefinitely IRC § 172(b)(1)(A).

f. Section 179 Expensing

i. TCJA increases the § 179 expensing limitation from $500,000 of property to $1 million.

   1. Increases the phaseout limitation to begin when property placed in service during the tax year exceeds $2.5 million.

ii. TCJA expands the definition of qualified real property to include HVAC systems, fire protection & security systems, and certain depreciable tangible personal property used predominantly to furnish lodging or in connection with the furnishing of lodging.

g. Business Interest Deductions
i. TCJA limits the deduction of business interest expense (less business interest income) to 30% of a business’s adjusted taxable income.

   1. Disallowed interest carried forward indefinitely

ii. Adjusted taxable income is computed without regard to any item of income, gain, deduction, or loss that is not properly allocable to a trade or business, business interest or business interest income, net-operating-loss (NOL) deductions, Sec. 199A deductions, and any depreciation, amortization, or depletion before 2022.

h. TCJA Adds Credit for Paid Family and Medical Leave

   i. The TCJA added a new tax credit for employers that offer paid family and medical leave to their employees. It applies to wages paid in tax years beginning after Dec. 31, 2017, and before Jan. 1, 2020.

   ii. The credit is a percentage of wages (as determined for Federal Unemployment Tax Act (FUTA) purposes and without regard to the $7,000 FUTA wage limitation) paid to a qualifying employee while on family and medical leave for up to 12 weeks per tax year.

   iii. The percentage can range from 12.5% to 25%, depending on the percentage of wages paid during the leave. See Notice 2018-71.
Deductions: Much Has Changed

By: R. Brian Gardner, III

December 13, 2018
State Bar of Georgia, Atlanta, Ga.
What Every General Practitioner Should Know About
The New Tax Laws

Overview

• Changes to the Standard Deduction
• Deduction Changes for Individuals
• Potential Workarounds
• Deduction Changes for Businesses
Income Tax Rates

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The New Standard Deduction

<table>
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<tr>
<th>Filing Status</th>
<th>Prior to TCJA</th>
<th>After TCJA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$6,350</td>
<td>$12,000</td>
</tr>
<tr>
<td>Married Filing Jointly</td>
<td>$12,700</td>
<td>$24,000</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$6,350</td>
<td>$12,000</td>
</tr>
<tr>
<td>Married Filing Separately</td>
<td>$9,350</td>
<td>$18,000</td>
</tr>
</tbody>
</table>
Surviving Deductions

- TCJA increased the limit for charitable contributions from 50% of AGI to 60% of AGI.
  - Taxpayers should consider bunching charitable deductions and itemizing their deductions in those years.
- Student Loan Interest – Limited to $2,500. Subject to modified adjusted gross income phaseout.
- Educator Expenses - $250 above-the-line deduction for educators spending on books, supplies, etc.

Modified Deductions

- Home Mortgage Interest – Taxpayers may only deduct interest on acquisition indebtedness under the TCJA i.e. mortgage used to buy, build or improve their home up to $750,000.
  - For mortgages taken out before December 15, 2017, the limit is $1 million for taxpayer married filing jointly.
- SALT Deductions - Deductions for State and Local sales, income and property taxes together may not exceed $10,000.
- Medical and Dental Expenses – Increased “floor” for medical and dental expenses to 7.5% of AGI.
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Eliminated Deductions


• Casualty and Theft Losses – TCJA repealed the deduction for casualty and theft losses except for those losses attributable to a federal disaster declared by the President.

• Settlements Paid in Connection with Sexual Harassment or Sexual Abuse Subject to NDA’s: No deduction for any settlement, payout, or attorneys fees if they are subject to a nondisclosure agreement.

• Settlements Paid in Connection with Sexual Harassment or Sexual Abuse Subject to NDA’s: No deduction for any settlement, payout, or attorneys fees if they are subject to a nondisclosure agreement. IRC § 162(q).

• Unreimbursed Employee Business Expenses – TCJA suspended all miscellaneous itemized deductions that are subject to the 2% of AGI floor.
### Common Unreimbursed Expenses Previously Deductible by Employees

1. Casualty and theft losses from property used in performing services as an employee,
2. Business bad debt of an employee,
3. Business liability insurance premiums,
4. Damages paid to a former employer for breach of an employment contract,
5. Depreciation on a computer a employee's employer requires her to use in her work,
6. Dues to a chamber of commerce if membership helps the employee perform their job,
7. Dues to professional societies,
8. Educator expenses,
9. Home office or part of a employee's home used regularly and exclusively in their work,
10. Job search expenses in the employee's present occupation,
11. Legal fees related to the employee's job,
12. Licenses and regulatory fees,
13. Malpractice insurance premiums,
14. Medical examinations required by an employer,
15. Occupational taxes,
16. Passport fees for a business trip,
17. Research expenses of a college professor,
18. Subscriptions to professional journals and trade magazines related to the employee's work,
19. Tools and supplies used in the employee's work,
20. Costs for travel, transportation, meals, entertainment, gifts, and local lodging related to the employee's work,
21. Union dues and expenses,
22. Work clothes and uniforms if required and not suitable for everyday use; and
23. Work-related education.

### But My Employees Really Want Those Deductions

- **Quick Fix** – We’ll make our employees independent contractors.
  - Don’t forget the 20-Factor Test
- **Three Main Categories:**
  - **Behavioral**: Does the company control or have the right to control what the worker does and how the worker does his or her job?
  - **Financial**: Are the business aspects of the worker’s job controlled by the payer? (These include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
  - **Type of Relationship**: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?
But My Employees Really Want Those Deductions

- What about making them statutory employees?
  - Statutory employees: If someone who works for you isn't an employee under the common law rules discussed earlier, don't withhold federal income tax from his or her pay, unless backup withholding applies.
  - Although statutory employees may not be common law employees, they're considered employees by statute for social security, Medicare, and FUTA tax purposes under certain conditions.
  - Statutory employees receive a Form W-2 that will have box 13, Statutory Employee, checked.
  - Statutory employee reports income and expenses on Schedule C.

Who is a Statutory Employee?

- An agent (or commission) driver who delivers food, beverages (other than milk), laundry, or dry cleaning for someone else.
- A full-time life insurance salesperson who sells primarily for one company.
- A homeworker who works by guidelines of the person for whom the work is done, with materials furnished by and returned to that person or to someone that person designates.
- A traveling or city salesperson (other than an agent-driver or commission-driver) who works full time (except for sideline sales activities) for one firm or person getting orders from customers. The orders must be for merchandise for resale or supplies for use in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging. See IRC § 3121(d)(3).
Traveling or City Salesperson

- Worker must exhibit more of the traits of an independent contractor than of a common law employee. See Hathaway v. Commissioner, T.C. Memo. 1996-389.
- Relevant Factors:
  - TP paid on a commission basis
  - TP paid his own business expenses
  - TP paid assistants
  - TP paid the cost of maintaining a business headquarters
  - TP guaranteed customer credit in some situations.

Consequences for Misclassifying Employee

- If the misclassification was unintentional, the employer could face the following penalties:
  - $50 for each W-2 the employer failed to file
  - 1.5% of the wages, plus 40% of the FICA taxes that were not withheld from the employee, plus 100% of the matching FICA taxes the employer should have paid.
  - Failure to Pay penalties.
- If the misclassification is intentional, employer could be subject to penalties that include 20% of all of the wages paid, plus 100% of the employee and employer’s share of FICA taxes.
- Not to mention trouble with the Departments of Labor
Business Deductions: Entertainment

• Business Entertainment – TCJA eliminates 50% deduction for entertainment, amusement or recreation directly related to the business.
  – Eliminates deductions for sports tickets, country clubs, concert tickets, etc. Treas. Reg. § 1.274-2(b)(1)(i)
• Entertainment does not include:
  – Dinner money provided by an employer to an employee working overtime,
  – Hotel room maintained by an employer for lodging of employees while in business travel status, or
  – A vehicle used in the active conduct of a trade or business even though also used for routine personal purposes.

Business Deductions: Meals

• IRS Notice 2018-76: Provides limited guidance and announces regulations are coming to address deductibility of business meals.
• § 274(k) provides that taxpayers may deduct 50% of an otherwise allowable business meal expense if:
  – (1) the expense is an ordinary and necessary expense paid or incurred during the tax year in carrying on a trade or business;
  – (2) the expense isn't lavish or extravagant under the circumstances;
  – (3) the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
  – (4) the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
  – (5) if food and beverages are provided during or at an entertainment activity, then they're bought separately from the entertainment, or their cost is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.
    • The food and beverage charge can't be inflated to circumvent the entertainment disallowance rule.
Example 1 from Notice 2018-76

• (i) Taxpayer A invites B, a business contact, to a baseball game. A purchases tickets for A and B to attend the game. While at the game, A buys hot dogs and drinks for A and B.

• (ii) The baseball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by A. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game.

Example 2 from Notice 2018-76

• (i) Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages.

• (ii) The basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may not deduct any of the expenses associated with the basketball game.

Employee Meals on Company Premises

• Employee meals on company premises subject to two sets of rules:
  – (1) For amounts paid or incurred after 2017 and before 2026, these meals are exempt from the general disallowance of deductions for entertainment.
  – (2) For amounts paid or incurred after 2025, no deduction will be allowed for: any expense for the operation of an employer-operated eating facility, any expense for food or beverages associated with an employer-operated eating facility; or any expense for meals on employer's premises.
Example 3 from Notice 2018-76

• (i) Assume the same facts as in Example 2, except that the invoice for the basketball game tickets separately states the cost of the food and beverages.

• (ii) As in Example 2, the basketball game is entertainment as defined in § 1.274-2(b)(1)(i) and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game.

Employee Meals on Company Premises

• Employee meals on company premises subject to two sets of rules:
  – (1) For amounts paid or incurred after 2017 and before 2026, these meals are exempt from the general disallowance of deductions for entertainment.
    • However, the meals are still subject to the 50% limitation for meal expenses;
  – (2) For amounts paid or incurred after 2025, no deduction will be allowed for: any expense for the operation of an employer-operated eating facility, any expense for food or beverages associated with an employer-operated eating facility; or any expense for meals on employer’s premises.
Net Operating Losses

Pre-2018
• NOL could be carried back two years and forward up to 20 years.
• Special extended carryback periods were allowed for NOLs attributable to certain specified liability losses and certain casualty and disaster losses.

TCJA
• NOL deduction for tax year is equal to the lesser of
  – (1) the aggregate of the NOL carryovers to such year, plus the NOL carry-backs to such year, or
  – (2) 80% of taxable income (determined without regard to the deduction). IRC § 172(a).
• Generally, NOLs can no longer be carried back but are allowed to be carried forward indefinitely IRC § 172(b)(1)(A).

Section 179 Expensing

• TCJA increases the § 179 expensing limitation from $500,000 of property to $1 million.
  – Increases the phaseout limitation to begin when property placed in service during the tax year exceeds $2.5 million.
• TCJA expands the definition of qualified real property to include HVAC systems, fire protection & security systems, and certain depreciable tangible personal property used predominantly to furnish lodging or in connection with the furnishing of lodging.
Business Interest Deductions

- TCJA limits the deduction of business interest expense (less business interest income) to 30% of a business’s adjusted taxable income.
  - Disallowed interest carried forward indefinitely
- Adjusted taxable income is computed without regard to any item of income, gain, deduction, or loss that is not properly allocable to a trade or business, business interest or business interest income, net-operating-loss (NOL) deductions, Sec. 199A deductions, and any depreciation, amortization, or depletion before 2022

TCJA Adds Credit for Paid Family and Medical Leave

- The TCJA added a new tax credit for employers that offer paid family and medical leave to their employees. It applies to wages paid in tax years beginning after Dec. 31, 2017, and before Jan. 1, 2020.
- The credit is a percentage of wages (as determined for Federal Unemployment Tax Act (FUTA) purposes and without regard to the $7,000 FUTA wage limitation) paid to a qualifying employee while on family and medical leave for up to 12 weeks per tax year.
- The percentage can range from 12.5% to 25%, depending on the percentage of wages paid during the leave. See Notice 2018-71.
Thank you.
R. Brian Gardner, III
bgardner@taylorenglish.com
P: (678) 336-7180
9:15

**CHOICE OF ENTITY DETERMINATIONS POST-TAX REFORM**

*Zachary D. “Zach” Wilson*, Arnall Golden Gregory LLP, Atlanta

*Matthew R. Peurach*, Morris Manning & Martin LLP, Atlanta
Introduction

Until the Tax Cuts and Jobs Act (“TCJA”), choice of entity was relatively well settled. The TCJA changes have complicated choice of entity decisions significantly.
Introduction

The new complexity comes from two fundamental changes that ripple through choice of entity planning:

1. Under TCJA the maximum corporate federal income tax rate of 21% is now lower than the maximum individual ordinary federal income tax rate of 37%.

2. The new section 199A 20% so-called flow-through deduction for Qualified Business Income.

Entity Classification Basics

Types of Business Entities:
1. Corporation
2. Limited Liability Company
3. Partnerships (GPs, LPs, LLPs, etc.)

Taxes often considered single most important factor in choice of entity.
Entity Classification Basics

Tax Classification of Business Entities:
1. Disregarded Entity (LLCs)
2. Partnership (GPs, LPs, LLLP, LLPs, LLCs)
3. C-Corporation
4. S-Corporation

Pros and Cons of DE and Partnerships:
1. Pros
   1. No Double Taxation
   2. Flexible
   3. Easy
2. Con
   1. Limited liability not always available
   2. Raising capital

Example of Double Taxation

<table>
<thead>
<tr>
<th>Without IRC 199A</th>
<th>C Corporation</th>
<th>Sole Prop, P’ship Rate of Corporate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income B4 Salary</td>
<td>$1,000,000.00</td>
<td>$1,000,000.00</td>
</tr>
<tr>
<td>Salary</td>
<td>($315,000.00)</td>
<td>($315,000.00)</td>
</tr>
<tr>
<td>Tax Rate on Dividends</td>
<td>0.21</td>
<td>0.21</td>
</tr>
<tr>
<td>Entity Taxable Income</td>
<td>$685,000.00</td>
<td>$685,000.00</td>
</tr>
<tr>
<td>Entity Level Tax</td>
<td>($143,850.00)</td>
<td>$0.00</td>
</tr>
<tr>
<td>Individual Income Tax Rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend/Distribution</td>
<td>$541,150.00</td>
<td>$685,000.00</td>
</tr>
<tr>
<td>Tax on Div or Dist**</td>
<td>($128,793.70)</td>
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<td>($116,550.00)</td>
</tr>
<tr>
<td>After -Tax Dollars</td>
<td>$610,806.30</td>
<td>$630,000.00</td>
</tr>
</tbody>
</table>
**Entity Classification Basics**

**Pros and Cons of C Corporations:**

1. **Pros**
   1. Limited liability
   2. Raising capital

2. **Con**
   1. Double taxation
   2. Not flexible (corporate formalities, statutory regime).

**Example of Double Taxation**

<table>
<thead>
<tr>
<th>Without IRC 199A</th>
<th>C Corporation</th>
<th>Sole Proprietorship</th>
<th>Rate &amp; Corporate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income + Salary</td>
<td>$1,000,000.00</td>
<td>$1,000,000.00</td>
<td>0.21</td>
</tr>
<tr>
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</tr>
<tr>
<td>Entity Taxable Income</td>
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<td>$685,000.00</td>
<td>0.2</td>
</tr>
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</table>
Entity Classification Basics

Pros and Cons of S - Corporations:

1. Pros
   1. Limited liability
   2. Single level of taxation
   3. No self employment tax on flow through income

2. Con
   1. Not flexible (must meet many requirements to qualify as an S corporation).
   2. Raising capital is difficult

Entity Classification Basics

S – Corporation Requirements:

1. 100 shareholder limit
2. Individual shareholders (limited exceptions)
3. No nonresident alien shareholders
4. Single class of stock
Entity Classification Basics

S – Corporation Taxation

<table>
<thead>
<tr>
<th>Without IRC 199A</th>
<th>S Corporation</th>
<th>Sole Prop., Partnership</th>
<th>Rate of Corporate Tax</th>
</tr>
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<tr>
<td>Net Income B4 Salary</td>
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<tr>
<td>SST</td>
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<td>($44,958.80)</td>
<td>$315,000.00</td>
</tr>
<tr>
<td>After-Tax Dollars</td>
<td>$604,906.20</td>
<td>$585,041.20</td>
<td></td>
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Entity Classification Basics

Limited Liability Company can be either:

1. C-Corporation
2. S-Corporation
3. Partnership
4. Disregarded Entity
Entity Classification Basics

LLC Classifications
1. Disregarded Entity - if one owner
2. Partnership - if more than one owner.
3. Check the Box Regime
   1. Initial Classification Election – LLC can elect to be a C corporation. LLC can also make an S election if requirements are satisfied.
   2. State law corporation is not an eligible entity (cannot elect classification).
   3. Must retain classification for 60 months unless it is a change in initial classification election.

Introduction

Because of the rate inversion, we have gone “back to the future” – the way the world was before the Internal Revenue Code of 1986 was adopted. C corporations now present the opportunity to accumulate capital at a lower tax cost than can be accumulated by individuals.
Introduction

However, C corporations continue to be subject to the bane of double taxation. This is illustrated by the following simplified example.

<table>
<thead>
<tr>
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Introduction

So now in choice of entity planning, one must work through the following matrix of issues:

- Effective tax rates
- Avoidance of double taxation
- Section 199A “Qualified Business Income” deduction
- Section 1411 “Net Investment Income Tax”
- Section 1202 “Qualified Small Business”
- Basis step-up at death considerations

These issues become particularly important in the context of “exit” transactions – i.e. where a business or ownership in a business is sold.
Introduction

The question about choice of entity can always be answered correctly if one can only foresee the future.

Introduction - Method of Exit

The method of exit is often critical in the choice of entity:

- **Asset Sale** — S corporation or LLC will be the best as it permits one level of tax and basis step-up by acquirer.
Introduction - Method of Exit

**Taxable Equity Sale** — Either an S corporation (with a 338(h)(10) election) or an LLC will be best because of the ability of the sellers to pay one level of tax, generally capital gain, while the buyers can obtain a basis step-up in the assets of the business.

---

**Taxable Equity Sale** — Section 1411 3.8% Medicare tax makes avoiding passive activity characterization even more valuable. Thus, LLCs and S corporations will be even more attractive to owners who actively participate as sales of assets or equity held by those who can avoid “passive activity” characterization is obtained.
Introduction - Method of Exit

- Section 1202 Exclusion may be available for stock in certain small business C corporations held more than 5 years by the original owner.

Introduction - Method of Exit

- **Stock Deal in a Tax Deferred Reorganization** — S corporation or C corporation is the way to go, as LLCs cannot participate on a tax-deferred basis.
Introduction - Method of Exit

- **IPO** — A flow-thru entity (LLC or S corporation) may save client millions in taxes.

Introduction

- The dilemma is that the choice of entity decision is generally uni-directional.
Introduction

- It is generally possible to move from an LLC or a limited partnership into the corporate form on a tax-free basis.

Introduction

- It is rarely possible to go from a corporate setting to an LLC or other partnership tax status without paying a significant tax toll.
Entity Choice Rules of Thumb

- Where they can be used, an S corporation may be the best alternative.
- Generally, an LLC taxed as a partnership should be considered for any new business that cannot qualify as an S corporation.
- A Georgia LLP or LLLP is almost as good as an LLC.

Entity Choice Rules of Thumb

Notwithstanding these complexities, certain “rules of thumb” seem reasonably clear.
Entity Choice Rules of Thumb

For closely held businesses where no exit is likely and where capital is accumulated and reinvested, again, a C corporation may be most effective. In particular, if this is coupled with a buyout of a deceased shareholder’s stock, this, coupled with the new expanded estate tax exemption may make this a perfect opportunity to bail earnings out with no second tier of gain.

Entity Choice Rules of Thumb

If one has a business that produces “good” qualified business income, an S Corporation is generally the way to go as it will enable the entity to pay wages, thus permitting the owner to take advantage of 199A at least to the extent of 50% of wages paid. This is to be contrasted with an LLC or sole proprietorship where amounts paid to partners/owners can never constitute wages. The S Corporation also avoids the Section 1411 net investment income tax for material participants while permitting stepped up basis and one level of tax on acquisitions.
Entity Choice Rules of Thumb

- Existing sole proprietorship clients should consider an S Corporation immediately to take advantage of Section 199A.
- However, the transfer of assets to the S Corporation may entail some legal costs and/or transfer taxes.

Entity Choice Rules of Thumb

- Existing partnerships (especially general partnerships) should consider converting to an LLC.
- Alternatively, consider an LLP election.
Entity Choice Rules of Thumb

Single-Member LLCs

- Instead of wholly owned subsidiaries, corporate clients should consider single-member LLCs:
  - Provides liability protection.

Entity Choice Rules of Thumb

Single-Member LLCs

- Treated like a division for tax purposes.
Entity Choice Rules of Thumb
Single-Member LLCs

- Even an S corporation may use a single-member LLC like a subsidiary.

Entity Choice Rules of Thumb
Single-Member LLCs

- May be advantageous for state income tax purposes where federal treatment is followed for single-member LLCs but consolidated returns are not allowed.
Entity Choice Rules of Thumb

Single-Member LLCs

Even an S corporation may use a single-member LLC like a subsidiary.

May be advantageous for state income tax purposes where federal treatment is followed for single-member LLCs but consolidated returns are not allowed.

Multiple-Tier Disregarded Entities

- Note impact of Section 1411 3.8% Medicare tax on S corporation decision. If owner “materially participates” an S corporation or LLC can result in dramatic savings.
- If assets are expected to appreciate substantially (such as real estate), LLC may still be the better choice.
Entity Choice Rules of Thumb

- If startup losses are anticipated, an LLC probably is a better choice, with potential conversion to S corporation status later (if at all).

C corporations may provide better fringe benefit results.

Fringe benefits may not be worth the added tax cost if the business eventually sells its assets.

Beware of other potential tax problems, e.g., reasonable compensation issues, personal holding company (Section 541), excised accumulated earnings (Section 531).
Entity Choice Rules of Thumb

- If the value of the business will never exceed the book value of its assets (e.g., a personal service business like a law firm), a C corporation may be beneficial.

Entity Choice Rules of Thumb

- If taxable income can be controlled and there is a need to accumulate capital at a low tax cost, a C corporation may well be the best choice.
Entity Choice Rules of Thumb

- If a merger with a public company or other corporation is likely in the near future, C or S status will permit tax-free merger treatment.

Entity Choice Rules of Thumb

- LLC taxed as a partnership status does not permit tax-free reorganization. It may be impossible to incorporate immediately prior to the merger.
Entity Choice Rules of Thumb

- If the entity is being used for estate planning and asset protection purposes, a Georgia FLP that makes the LLLP election is the better choice.

Entity Choice Rules of Thumb

- Look for opportunities to convert corporations to LLCs (rather than actually liquidate) or to convert LLCs to tax corporations (rather than actually incorporate under state law).
Entity Choice Rules of Thumb

- Conversion avoids transferring assets and may involve little disruption of the business, but the advisor must be mindful of the tax implications.

Entity Choice Rules of Thumb

- Qualified Plans generally will not invest directly in LLCs or other entities taxed as partnerships because of:
  - Unrelated Debt Financed Income ("UDFI"),
  - Unrelated Business Taxable Income ("UBTI"),
  - K-1s, and
  - Allocations to investors.
Entity Choice Rules of Thumb

- If you are looking for Qualified Plans to be investors in a business, do not choose an LLC or other partnership entity, except on a transitory basis.

Entity Choice Rules of Thumb

- Venture Funds will generally not invest directly in LLCs or other entities taxed as partnerships because:
  - They do not want K-1 income, and
  - They do not want the obligation of reporting to the investor.
Entity Choice Rule of Thumb

- Venture Funds, Qualified Plans and other exempt entities will sometimes invest in LLC’s through “Blocker” corporations.

Entity Choice Rules of Thumb

- Venture Funds and other investment entities will almost always be structured as either LLCs or LPs.
- Foreign investors often prefer LPs due to uncertain characterization of LLCs under non-US law.
- This choice permits distribution of appreciated securities without current tax.
Entity Choice Rules of Thumb

- An LLC or LP continues to be the best vehicle for real estate investment or development:
  - Flexibility of ownership, and
  - Ability to distribute proceeds without entity level tax.
  - Inclusion of non-recourse debt in outside basis.
  - Basis step-up at death with 754 election.

Entity Choice Rules of Thumb

- C corporations are easier to understand and somewhat less expensive for most clients and investors for tax and accounting purposes.
- C corporations can accumulate capital at lower marginal rates. For capital intensive businesses or family businesses, this may carry the day.
Entity Choice Rules of Thumb

- LLCs are infinitely flexible, but they take more work because flexibility requires many more decisions.
- This may suggest an S or C corporation, again particularly with small businesses not likely to enjoy asset appreciation.

Entity Choice Rules of Thumb

- Some LLC owners are frustrated by not being able to be treated as employees subject to withholding.
- An S corporation can solve this problem nicely, if this alternative is available.
LLC tax as Partnership with S Corp Members

Self-Employment Tax Issues for Members of LLCs

- Other alternatives to escape the issue include use of a subsidiary payroll corporation or employee leasing company. Note, that may not be attractive from a Section 199A perspective.
LLC with Payroll Subsidiary

LLC with Employee Leasing Company

Entity Choice Rules of Thumb

LLPs are rarely practical entities, except for professional or other service firms.

Ultimate Entity Preferred S Corp C Corp Common Preferred

Investment Fund Foreign Owner LP (Operating Business) C Corp 1 C Corp 2
Entity Choice Rules of Thumb

- LLPs are rarely practical entities, except for professional or other service firms.
Thank you for your attendance today. If you have any questions, please contact the Speakers.

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AN ALL NEW TAX INCENTIVE: OPPORTUNITY ZONES

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Overview/Summary of Tax Benefits

- General concept is similar to Sections 1031 and 1033 of the Code, permitting nonrecognition (via deferral) of reinvested gain.
- Better/more powerful in certain respects.
- But various uncertainties in absence of further guidance.
Overview/Summary of Tax Benefits

- Section 1031 now limited to real property; QOF program is not (either with respect to property sold or QOF investment).
- No cash/transaction tracing requirement; no QI equivalent.
- Except as otherwise indicated, taxpayer will have an initial basis in new investment of zero (because the investment is being made with untaxed cash).
- Income generated by the QOZ Business (discussed below) is not deferred.
- First benefit: Deferral of gain.

Amount Recognized

The deferral with respect to the gain reinvested ceases on the earlier to occur of (1) the sale of the investment or (2) December 31, 2026. The amount of gain included in gross income at such time is equal to:

THE LESSER OF:

1. Amount of gain deferred
   or
2. The fair market value of investment in QOF interest

MINUS:

Taxpayer’s basis in the QOF interest

Note: The taxpayer’s basis in the Opportunity Fund is initially deemed to be zero.
Overview/Summary of Tax Benefits

Second benefit: Potential reduction of deferred gain.
- 10% reduction of gain on original (disposed of) investment if new QOF investment is held for at least 5 years.
- 15% reduction of gain (i.e. an additional 5% reduction of gain) on original investment if new QOF investment is held for at least 7.
- Investors seeking 15% reduction must invest prior to December 31, 2019 years since it would not be possible to satisfy the 7 year holding period before 12/31/26 when the deferral period ends.
- Investors seeking 10% reduction must invest prior to December 31, 2021 years since it would not be possible to satisfy the 5 year holding period before 12/31/26 when the deferral period ends.

Overview/Summary of Tax Benefits

Third Benefit: No tax on gain attributable to the appreciation in the new QOF investment if held for at least 10 years.
- The investor’s basis in the QOF investment will be the FMV of the investment when it is sold or exchanged (after 10 years & if investor makes affirmative election upon sale).
- Unlike the 10% and 15% reduction in gain benefits, this benefit is available so long as a qualifying investment is made on or before December 31, 2026.
Overview/Summary of Tax Benefits

Example: On August 7, 2018, Taxpayer sells LSAT stock for $10 million (after its CEO tweets that he is taking the company private, then public, then private again... maybe). Had basis of $9 million. Within 180 days, Taxpayer invests $1 million of gain in a partnership that meets the QOF requirements.

- Taxpayer has $0 basis in her new QOF investment, $9 million in her pocket, and has no gain from the sale in 2018.
- After 5 years, basis increases to $100,000.
- After 7 years, basis increases to $150,000.
- Assuming no prior sale, on December 31, 2026, Taxpayer has $850,000 gain and must pay tax on that gain.
- Assuming no prior sale, after 10 years of ownership of QOF investment, the investment is worth $2 million.
- If sold at this time (or later), Taxpayer receives $2 million in sales proceeds but recognizes $0 gain on the $1m of appreciation in the investment (basis increased to FMV on date of sale).
State Tax Implications

- Opportunity Zone benefits increase if states conform to the Federal Law
- Some states piggy-back off of the current Federal Law but could decouple from OZs
  - New York decided not to decouple
  - Hawaii decided to decouple
  - North Carolina released a draft bill that would decouple
- Some states do not conform to Federal Law but could add OZs at the state level
  - Colorado is considering a bill to add the OZ benefit at the state level
- Some states do not have a state income tax (e.g. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming).
- State Tax Implications of an single OZ transaction may include multiple states
  - State where original gain was realized
  - State(s) where the opportunity fund has nexus
- Some states are tying other State incentives to opportunity zones
  - Missouri proposed increased cap for state historic credits for properties in OZs
  - California introduced a bill to exempt projects in OZs from the CA Environmental Quality Act
  - Ohio introduced a bill to create a 10% state tax credit for taxpayers who invest in an OH-based QOF

Qualified Opportunity Fund
State Tax Implications

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Qualified Opportunity Fund

**Statutory Requirements**
- Corporation or Partnership
- Purpose
- Assets Test*

**Certification Process**

**Noncompliance Penalty**

Qualified Opportunity Fund - Purpose

An investment vehicle organized as a corporation or a partnership for the purpose of investing in Qualified Opportunity Zone Property (QOZP).
Qualified Opportunity Fund – Assets Test

Must hold at least 90% of assets in QOZP, determined by the average of the percentage of QOZP held on:

- The last day of the first six month period of the fund’s taxable year, and
- The last day of the fund’s taxable year

Certification Process

- An eligible taxpayer self-certifies to become a certified qualified opportunity fund.
- No approval or action by the IRS is required.
- A taxpayer merely completes a form (which will be released in the summer of 2018) and attaches that form to the taxpayer’s federal income tax return for the taxable year.
- The return must be filed timely, taking extensions into account.
Certification Process

- IRS announces self-certification process for QOFs on April 24
- Self-certification form to be attached to tax return
- Form to be published summer 2018
Qualified Opportunity Zone Stock and Partnership Interest

- The investment must be acquired after December 31, 2017 solely in exchange for cash;
- Must be a qualified opportunity zone business, or is being organized for the purpose of being a qualified opportunity zone business;
- Must remain a qualified opportunity zone business for substantially all of the qualified opportunity fund’s holding period

Qualified Opportunity Zone Business (QOZB)

A trade or business in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (QOZBP) and:

- At least 50% of income derived from Active Conduct
- Substantial portion of intangible property used in active conduct of business
- < 5 percent unadjusted basis of property is nonqualified financial property
**QOZB: Excluded Businesses**

*Can’t be a “Sin Business”*

A private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

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**Qualified Opportunity Zone Business Property (QOZBP)**

- Tangible property used in a trade or business
- Acquired by purchase from an unrelated party (20% standard) after December 31, 2017
- During substantially all of holding period, substantially all the use is in a QOZ
- Original use in the QOZ commences with the taxpayer OR
  - Taxpayer substantially improves the property
    - during any 30-month period after acquisition, additions to basis exceed an amount equal to the adjusted basis of such property at the beginning of such period
Readily Identifiable Investment Types in Opportunity Zones

- Commercial Real Estate Development and Renovation in Opportunity Zones
- Opening New Businesses in Opportunity Zones
- Expansion of Existing Businesses into Opportunity Zones
- Large Expansions of Businesses already within Opportunity Zones

Questions?
CAN I REALLY DEDUCT 20% OF MY INCOME UNDER 199A?
Robert A. Beard, King & Spalding LLP, Atlanta
Julian A. Fortuna, Taylor English Duma LLP, Atlanta
Can I Really Deduct 20% of My Income Under Section 199A?

December 13, 2018

Robert Beard  
*King & Spalding LLP*

Julian Fortuna  
*Taylor English Duma LLP*

• Section 199A is the most economically significant tax reform provision for businesses operating in a passthrough structure and can potentially reduce the tax liability for owners of such businesses by 20%.

• On the other hand, if the section 199A benefit is not available to owners of a business, it may be more attractive to operate that business in a C corporation format, which is a significant change from the "standard" tax planning advice prior to tax reform.

• Section 199A has acquired a reputation as an intimidating and complex provision. While this is certainly true about many of the details, the general outlines of the provision can and should be understood by the general practitioner. Most of the really complex stuff relates to calculating the allowed deduction and will primarily trouble the accountants.

Why is Section 199A Important?

• Prior to the Tax Cuts and Jobs Act (“TCJA”) passed in December 2017, the U.S. had one of the highest corporate tax rates among developed countries, at 35%. However, the tax code was riddled with corporate deductions and planning opportunities that allowed many corporations to push the effective tax rate they actually paid far below the statutory number.

• This unsatisfactory state of affairs created a push for tax reform legislation that would lower the tax rate, but "broaden the base" to which that tax rate would apply, by eliminating deductions and closing loopholes.

• TCJA implemented this vision, at least in some respects. One of the centerpieces was a dramatic cut in the corporate tax rate, from 35% down to 21%. TCJA also included a raft of base-broadening measures.

Why Did Congress Do This?

• Recall that C corporations pay tax at two levels: First, the corporation pays tax when income is earned, at the corporate tax rate. Then, the shareholder pays tax when the income is distributed as a dividend. The shareholder rate was 20% before and after TCJA (plus a 3.8% Medicare tax).

• Prior to TCJA, most businesses that had the option chose to operate in a passthrough structure. In a passthrough structure, the owners of the business pay tax at their ordinary income tax rate when income is earned. For individuals, this rate was formerly a maximum of 39.6%, which was slightly reduced to a maximum of 37% under TCJA.
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Why Did Congress Do This?

- Pre-TJCA, passthrough structures were favored for most U.S. taxable investors. A major concern was that the drastic corporate rate cut would upend the playing field by making “double tax” structures paradoxically cheaper than passthroughs.
- Congress’s solution was to make a parallel reduction in the tax cost of passthrough structures by enacting the new 20% deduction on “qualified business income” (“QBI”) from such structures.
- The QBI deduction only applies to certain ordinary income that would otherwise be taxed at up to 37%. If the full deduction applies, the maximum rate on QBI is reduced to 29.6%.

What Was Congress Worried About?

- While creating new tax breaks is easy and generally popular, Congress seems to have had some reservations about creating a new deduction of this size. While the legislative history does not explicitly spell out these concerns, these may have been policy goals:
  - Avoid creating a controversial tax windfall for the finance industry or other highly compensated professionals;
  - Avoid major revenue losses that would result if income from employee personal services benefited from the 20% deduction;
  - Don’t give the benefit of the deduction to investment income; and
  - Tie the tax break to job creation and investment.
- Finally, and presumably to help TCJA comply with the budget reconciliation requirements, section 199A sunsets after 2025.
Summary of C Corp vs. Passthrough Tax Rates

To see how the QBI deduction plays into business tax planning, consider the following simple example of the taxes payable on $100 of net income:

<table>
<thead>
<tr>
<th>Business Structure</th>
<th>Tax When Income is Earned</th>
<th>Tax When Income is Distributed</th>
<th>Combined Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>C Corporation</td>
<td>$21</td>
<td>$15.80</td>
<td>36.8%</td>
</tr>
<tr>
<td>Passthrough – QBI not available</td>
<td>$37</td>
<td>N/A</td>
<td>37%</td>
</tr>
<tr>
<td>Passthrough – with QBI</td>
<td>$29.60</td>
<td>N/A</td>
<td>29.6%</td>
</tr>
</tbody>
</table>

One striking consequence of these numbers is that a business that produces predominantly ordinary income that will not qualify for the QBI deduction (for example, an investment in a debt fund) may be best held in a C corporation, especially if income will not be immediately distributed.

Demystifying Section 199A

You may have seen flowcharts that look like this, and gotten the message that Section 199A is a complicated provision that business lawyers shouldn’t expect to understand. Don’t believe it!
Demystifying Section 199A

• For a general practitioner (and most specialists), the flowchart approach is not the right way to understand the QBI deduction. Instead, ask three questions:
  1. Is the income "qualified business income"—i.e., is it the right *kind* of income that might qualify for the deduction?
  2. If so, does the "specified service trade or business" limitation apply?
  3. If not, do you need to calculate the wage/basis cap?
• At the end of the analysis, you may conclude that the full 20% deduction applies, or you may conclude that the deduction may be subject to the wage/basis cap, in which case you (or the client’s accountants) need to calculate the amount of the cap.

Question 1 – Do you have qualified business income?

• The first conceptual question is whether the taxpayer has "qualified business income." QBI must be:
  • Income from a trade or business conducted in the U.S. (section 199A(c)(3)(A)(i), (d)(1));
  • Not from the trade or business of providing services as an employee (section 199A(d)(1)(B)); and
  • Must not consist of certain investment-type income: dividends, capital gain (including short-term capital gain and section 1231 gain), interest (other than interest from a bank or another lending trade or business) and certain other miscellaneous items (section 199A(c)(3)(B)).
• QBI does not include reasonable owner compensation or guaranteed payments for services. Section 199A(c)(4).
• Recall that the QBI deduction is intended to make conducting a business in the passthrough format relatively more attractive. These restrictions are designed to target the QBI benefit to businesses that commonly might be conducted through a C corporation.
Question 1 – Do you have qualified business income?

- The Proposed Regulations do not include a bespoke definition of a trade or business for QBI purposes. Instead, they rely on the general definition of trade or business that applies for purposes of section 162 (allowing business expense deductions). Prop. Reg. § 1.199A-1(b)(13).
  - Leasing of real property with no management activities may not qualify as a trade or business. See Rev. Rul. 73-522.
  - A special QBI rule provides that leasing tangible or intangible property to a related business is treated as a trade or business for QBI purposes. Prop. Reg. § 1.199A-1(b)(13).

- Net QBI income and losses from different qualifying businesses must be aggregated by a taxpayer to arrive at an overall net QBI amount. Section 199A(b)(1)(A); Prop. Reg. § 1.199A-1(c)(1), (d)(2)(iii)(A). Losses are only taken into account for this purpose to the extent allowed under the Code. Prop. Reg. § 1.199A-3(b)(2)(i)(B). Thus, passive activity losses or other items that are not currently deductible do not enter into the QBI calculation.

- If there is an overall QBI loss, then the loss amount is carried forward as a reduction in QBI for the next taxable year. Section 199A(c)(2).

- Note that the loss carryover rule does not affect the timing of the deduction for general income tax purposes. Rather, the carryover provision ensures that a taxpayer does not get the 20% deduction with respect to income while deducting losses at the full 37% rate. See also section 461(l).
Question 1 – Do you have qualified business income?

- Although the QBI deduction has been colloquially referred to as a “passthrough income” deduction, it is not necessary to earn income through a partnership or an LLC for it to apply. What is important is that the income is not earned through a C corporation or as an employee.
  - For example, a freelance photographer should qualify for the deduction, subject to the wage and basis cap (if it applies), even if the photographer conducts business in her personal capacity.
  - There is no QBI-specific definition of “employee” for this purpose, but the proposed regulations indicate that wages and other employee compensation under general tax principles is intended to be excluded from QBI. Prop. Reg. § 1.199A-5(d)(1).
  - There is a rebuttable presumption that an individual who was once classified as an employee will continue to be an employee, even if subsequently designated as an independent contractor, unless there has been a substantial change in the services provided. Prop. Reg. § 1.199A-5(d)(3).

Question 2 – Does the “specified service” rule apply?

- Congress didn’t want the QBI deduction to benefit the financial industry or other fancy-pants professionals, for reasons that seem to be based on optics (and perhaps revenue protection) more than any principled tax policy reasons.
- To implement this desire, the full QBI deduction is only available if one of two things is true:
  - The taxpayer claiming the deduction has taxable income of no more than $157,500 ($315,000 for a joint return) (section 199A(d)(3)); or
  - The relevant business is not a “specified services trade or business” (“SSTB”) (section 199A(d)(1)(A)).
- For taxpayers with income above the $157,500/$315,000, the QBI deduction phases out over the next $50,000/$100,000 of taxable income. Section 199A(d)(3).
Question 2 – Does the “specified service” rule apply?

• An SSTB is:
  • Investing, investment management, trading, or dealing in securities, partnership interests or commodities;
  • Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services; and
  • Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. Section 199A(d)(2); section 1202(e)(3)(A).

• The catch-all category of the trade or business whose principal asset is the skill or reputation of employees or owners created considerable consternation prior to the issuance of the proposed regulations. Arguably, many service businesses (at least successful ones) are reliant on the skill and reputation of employees. For example, an independent plumber is the archetypical small business, but also clearly relies on his skill and reputation to attract business.

The Proposed Regulations greatly narrowed the “reputation or skill” SSTB category. Specifically, the regulations provide that a business only falls into this category if it consists of:

• Receiving compensation for endorsements;
• Receiving licensing fees for the use of an individual’s image, likeness, name, signature, voice, trademark, or other associated symbols; or
• Appearing at events or on radio, television or other media for a fee. Prop. Reg. § 1.199A-5(b)(2)(xiv).

• The Proposed Regulations also include clarification on the scope of the other SSTB categories included in the statute. Prop. Reg. § 1.199A-5(b)(2).
Question 2 – Does the “specified service” rule apply?

- SSTBs also include related non-SSTB businesses that support an SSTB. Specifically, if a business: (a) provides more than 80% of its property or services to an SSTB, and (b) the recipient SSTB has 50% or greater common ownership, then the provider business is also treated as an SSTB. Prop. Reg. § 1.199A-5(c)(2)(i).
- If less than 80% of property or services are provided to a related SSTB, then a proportionate part of the provider business is rolled into the recipient SSTB. Prop. Reg. § 1.199A-5(c)(2)(ii).
- If a trade or business shares expenses with an SSTB and its gross revenue is less than 5% of total gross revenue, it is part of the SSTB it shares expenses with. Prop. Reg. § 1.199A-5(c)(3).
- On the other hand, if SSTB activities account for less than 10% of the gross revenue of a business (5% if total gross revenues exceed $25 million), the business is not an SSTB. Prop. Reg. § 1.199A-5(c)(1). Note that this produces a “cliff” effect for a business with $25,000,001 of gross revenue.

Question 2 – Does the “specified service” rule apply?

- Example. An accounting firm owned by two CPAs is conducted through an LLP taxed as a partnership. The office building used by the firm is owned by the two CPAs through an LLC, which leases space in the building to the LLP.
  - If the accounting firm occupies 80% or more of the office building, the LLC’s activities are an SSTB (including any leasing to third parties).
  - If not, a portion of the LLC’s activities are included in the accounting SSTB.
- Example. A law firm has an in-house transcription team and derives revenue from transcribing depositions for litigation clients. Although transcription services are not SSTBs, if the transcription business shares expenses with the law firm and accounts for less than 5% of revenues, it will be considered part of the legal SSTB.
Question 3 – Does the Wage/Basis Cap Apply?

- Congress also wanted to target the QBI deduction to business that create jobs for others and make investments in tangible property. As a result, for high-income taxpayers, the 20% deduction is capped by a formula that takes into account:
  1. The wages paid to employees and reported on Form W-2 (“W-2 wages”); and
  2. The original basis of qualified tangible property used in the business. Section 199A(b)(1).
- The same income thresholds and phaseouts that apply to the SSTB rules also apply to the wage/basis cap. Thus, taxpayers making less than $157,500 ($315,000 on a joint return) are not subject to the cap and don’t need to worry about the details. Section 199A(b)(3).

Demystifying Section 199A

- Although these rules have a lot of nuance, note that there are easy answers here for many taxpayers:
  - An unmarried freelance software consultant with a number of clients earns $100,000 a year from the business. He is entitled to the full 20% QBI deduction.
  - An accountant earns $450,000 a year from his business. No QBI deduction is allowed (due to the SSTB rules).
  - A married solo practitioner with a number of clients earns $200,000, and her husband earns $100,000 of wage income. The full 20% deduction applies to the income from the law practice (but not to the wage income).
  - An unmarried individual owns a 50% interest in a real estate project that generates $250,000 a year in income. The QBI deduction is available, subject to the wage and basis cap.
The Calculation – What is the Wage/Basis Cap?

• If the wage and basis cap applies, then the deduction is limited to the lesser of: (a) 20% of the QBI from the business or (b) the business's wage and basis cap. Section 199A(b)(2).
• The wage and basis cap is itself equal to the greater of:
  1. 50% of the W-2 wages paid by the business during the year; or
  2. 25% of the W-2 wages paid by the business, plus 2.5% of the unadjusted basis immediately after acquisition ("UBIA") of all qualified property used by the business.
• The cap is calculated and applied separately for each trade or business. Excess cap room from one business cannot be used to remedy a deficit in a different business.

The Calculation – What is the Wage/Basis Cap?

• To qualify as W-2 wages, amounts must properly be treated as wages and must literally be reported on a W-2 that is filed not more than 60 days after the due date. Prop. Reg. § 1.199A-2(b)(2)(iii).
• W-2 wages are taken into account by the common law employer, even if the W-2 is filed by a PEO, statutory employer, or agent. Prop. Reg. § 1.199A-2(b)(2)(ii).
• The amount of W-2 wages paid by a person must be allocated among the different trades or businesses carried on by that person. Then, W-2 wages of each business must be allocated between QBI and non-QBI of that business. Prop. Reg. § 1.199A-2(b)(2)(i).
• W-2 wages are allocated among S corp shareholders and partners of a partnership in the same manner as the corresponding wage deduction. Section 199A(f)(1)(A).
The Calculation – What is the Wage/Basis Cap?

- UBIA means tax basis when acquired, without adjustment for depreciation or similar adjustments. Prop. Reg. § 1.199A-2(c)(3).
  - An important clarification exists for property acquired in a section 1031 exchange or an involuntary conversion. In those cases, UBIA is determined at the time the replacement property is acquired. Prop. Reg. § 1.199A-2(c)(2)(iii). This rule means that a section 1031 exchange for depreciable property will result in UBIA being reduced to adjusted basis at the time of the exchange.
  - Qualified property is tangible, depreciable property that is held by, or available for use in, the business at the end of the year; is used to produce QBI during the year; and either has not been fully depreciated or has been in service for ten years or less at the end of the year. Prop. Reg. § 1.199A-2(c)(1).
    - Basis adjustments to partnership property arising from section 754 elections are not treated as qualified property. Prop. Reg. § 1.199A-2(c)(1)(iii).

The Calculation – What is the Wage/Basis Cap?

- The UBIA of qualified property is taken into account for the longer of two periods:
  - The prescribed depreciation life for the property under the MACRS cost recovery system (without regard to the expensing provisions of the Code); or
  - Ten years from the date the property is placed in service. Prop. Reg. § 1.199A-2(c)(2)(i).
  - The upshot of this rule is that long-lived property (like buildings) will be taken into account for the full depreciable life, while more rapidly depreciating investments (like machinery and equipment) count for ten years.
- If property is transferred in a nonrecognition transaction, the transferee’s basis on the date of the transfer is the UBIA. Prop. Reg. § 1.199A-2(c)(2)(iv); Ex. 3. As with section 1031 exchanges, this rule can be expected to result in a UBIA detriment from nonrecognition transfers.
The Calculation – What is the Wage/Basis Cap?

- Where property is held by a partnership or S corporation, section 199A(f)(1) provides that a partner’s share of UBI is determined in accordance with the partner’s share of depreciation or the shareholder’s pro rata share of depreciation.
- While the S corporation rule is unlikely to create confusion, the partner’s share of depreciation concept is less clear, and no additional details have been provided in the Proposed Regulations.
- Under section 704(c) of the Code, the allocation of depreciation from contributed property generally must take account of built-in gain existing when the property was contributed. Partnerships can apply different methods to account for built-in gain (such as the traditional method, the remedial method, etc.). The remedial method, in particular, may result in notional items of depreciation and offsetting income being created. Although section 704(c) adjustments presumably affect a partner’s share of UBI, it is unclear how notional remedial items should be taken into account.

Aggregation of Businesses

- Recall that the QBI deduction is generally evaluated on a business-by-business basis. However, the Proposed Regulations permit, but do not require, taxpayers to aggregate businesses if certain criteria are met.
- The aggregation criteria are generally much less flexible than the passive activity grouping rules.
- The decision to aggregate or not is generally made at the taxpayer level. Thus, two partners in a partnership that conducts two businesses eligible for aggregation may separately choose whether or not to aggregate them.
- Once a taxpayer chooses to aggregate two businesses, they must stay aggregated unless the facts change so that aggregation is no longer permissible. Prop. Reg. § 1.199A-4(c)(1).
Aggregation of Businesses

- To qualify for aggregation, two business must meet the following requirements:
  1. **Common ownership.** The same people must own 50% of both businesses. The businesses need not be conducted by the same entity.
  2. **Consistent taxable years.** All businesses must be reported on the same taxable year (discounting short years).
  3. **SSTBs not eligible.** None of the aggregated businesses may be SSTBs.
  4. **Business connection requirement.** Two of three criteria must be met:
     a) Products or services are the same or are customarily offered together.
     b) Shared facilities or “centralized business elements” (such as common back office functions).
     c) Operated in coordination with, or in reliance upon, another aggregated business.

Aggregation of Business Example

- Taxpayer owns three entities:
  1. LLC1 operates a trucking company that specializes in lumber deliveries.
  2. LLC2 operates a lumber yard.
  3. LLC3 operates a construction business.
- LLC1 delivers goods sold by LLC2, and LLC2 supplies the lumber used by LLC3.
- All of the businesses share a common HR, payroll and accounting department.
- Under the Proposed Regulations, the three business (or presumably any two) can be aggregated, because they share back-office functions and are operated in coordination or reliance on each other.
- Note that the regulations do not indicate how extensive the interdependence between businesses must be to permit aggregation. What if each business in this example primarily relies on third-party customers or suppliers?
Why Aggregate?

- The reason to aggregate businesses is to maximize the deduction available after application of the wage and basis cap.
- Recall that the cap is calculated and applied separately with respect to each business of a taxpayer. As a result, a business that pays lots of wages but doesn’t produce much net income generally cannot share its excess cap room with another business of the same taxpayer that produces lots of QBI, but has a low wage and basis cap.
- However, if the businesses can be aggregated, this limitation no longer applies.
- Aggregation is not useful for avoiding SSTB status by taking advantage of the de minimis 10% rule. SSTB status is apparently determined prior to aggregation, and SSTBs cannot be aggregated with other businesses.

Maximizing the Wage and Basis Cap

- Aggregation is helpful in many cases because it permits an aggregate cap to be used to support QBI deductions from different businesses.
- However, this general rule is subject to an important caveat relating to the calculation of the cap. Recall that the cap is either 50% of W-2 wages, or the sum of 25% of W-2 wages plus 2.5% of UBIA. In other words, every business gets to count 25% of its W-2 wages in its cap, but then faces a trade-off between counting 25% of W-2 wages or counting 2.5% of UBIA.
- If including UBIA produces a better cap answer, half of the benefit of the W-2 wages is wasted. If the 50% of W-2 wages formula is better, then all of the UBIA contribution is wasted.
- The trade-off can be avoided and the cap maximized by separating the businesses in two, with one business holding most of the qualified property and the other paying most of the W-2 wages.
The reason to aggregate businesses is to maximize the deduction available after application of the wage and basis cap. Recall that the cap is calculated and applied separately with respect to each business of a taxpayer. As a result, a business that pays lots of wages but doesn’t produce much net income generally cannot share its excess cap room with another business of the same taxpayer that produces lots of QBI, but has a low wage and basis cap. However, if the businesses can be aggregated, this limitation no longer applies.

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Aggregation is helpful in many cases because it permits an aggregate cap to be used to support QBI deductions from different businesses. However, this general rule is subject to an important caveat relating to the calculation of the cap. Recall that the cap is either 50% of W-2 wages, or the sum of 25% of W-2 wages plus 2.5% of UBIA. In other words, every business gets to count 25% of its W-2 wages in its cap, but then faces a trade-off between counting 25% of W-2 wages or counting 2.5% of UBIA.

If including UBIA produces a better cap answer, half of the benefit of the W-2 wages is wasted. If the 50% of W-2 wages formula is better, then all of the UBIA contribution is wasted. The trade-off can be avoided and the cap maximized by separating the businesses in two, with one business holding most of the qualified property and the other paying most of the W-2 wages.

Cap Planning Example

Owners

OpCo

Equipment and real estate

Workforce

UBIA = $1100

W-2 wages = $100

• Cap equals the greater of: (a) 50% of W-2 wages ($50) or (b) 25% of W-2 wages ($25) plus 2.5% of UBIA ($27.50).
• With these numbers, the cap under prong (b) and equals $52.50.

Cap Planning Example

Owners

OpCo

LeaseCo

Equipment and real estate

Workforce

Lease

UBIA = $1100

W-2 wages = $100

• OpCo cap is 50% of W-2 wages, or $50.
• LeaseCo cap is 2.5% of UBIA, or $27.50.
• Total cap is $77.50 (but must be applied separately to each business).
Maximizing the Wage and Basis Cap

- The Proposed Regulations include two helpful rules that support this type of planning:
  - First, the Proposed Regulations specially provide that renting or licensing property to a trade or business is itself a trade or business for QBI purposes, even if it would not otherwise so qualify. Prop. Reg. § 1.199A-1(b)(13).
  - Second, the preamble notes that “in most cases” a single trade or business cannot be conducted across multiple entities.
- Note that LeaseCo and OpCo likely could be aggregated if they share back-office functions if aggregation produces a better cap answer. Once electively aggregated, the businesses must stay together unless the facts change.

REITs and PTPs

- Recall that one of the overarching goals of section 199A is to preserve (at least to some extent) the relative differences between the tax rates on C corporations and passthrough business structures. The same concern exists with respect to REITs and publicly traded partnerships (PTPs).
- Accordingly, section 199A provides an equivalent 20% deduction for certain “qualified REIT dividends” and “qualified publicly traded partnership income” received by a noncorporate taxpayer. Section 199A(b)(1)(B). These amounts generally correspond to income from REITs and PTPs that does not qualify for the long-term capital gain rate.
- Under the Proposed Regulations, ordinary income and loss from REITs and PTPs must be aggregated with each other (but not with other QBI activities) before determining the 20% deduction. Prop. Reg. § 1.199A-1(d)(3). Note, however, that net PTP losses are almost never allowable to an LP under the passive loss rules, so this provision should have limited applicability.
REITs and PTPs

- Unlike the regular QBI deduction, the deduction for qualified REIT dividends and qualified PTP income is not subject to the wage and basis cap or the SSTB limitations. Presumably, this reflects a desire to limit the administrative complexity of the deduction for widely held vehicles and a reduced potential for abuse due to the income limitations applicable to both REITs and PTPs.

- If the QBI deduction from a real estate investment is limited by the wage and basis cap, holding the investment through a REIT should allow the full deduction to be taken. This planning technique may be especially useful where a property has reduced UBIA due to step downs resulting from section 1031 exchanges or other nonrecognition transactions.
2:30  THE NEW TAX LAWS’ IMPACT ON STATE TAXES
W. Scott Wright, Eversheds Sutherland (US) LLP, Atlanta
Alla Raykin, Eversheds Sutherland (US) LLP, Atlanta

Scott Wright & Alla Raykin
Eversheds Sutherland (US) LLP
Atlanta, Georgia

I. Background of TCJA
   a. On November 2, 2017, the House Ways and Means Committee released H.R. 1, the Tax Cuts and Jobs Act (the “House Bill”).
   b. On November 10, 2017, the Senate Finance Committee released the description of the Chairman’s markup on the Tax Cuts and Jobs Acts (the “Senate Bill”).
   c. On November 16, 2017, the House of Representatives passed the House Bill.
   d. On December 2, 2017, the Senate passed the Senate Bill.
   e. Given the substantive differences between the House Bill and the Senate Bill, a conference committee was convened to negotiate a bill agreeable to both houses.
   f. On December 15, 2017, the conference committee reported what would become the Final Bill.
   g. By December 20, 2017, the Senate and the House of Representatives passed the Final Bill.
   h. As a result of a ruling by the Senate parliamentarian, the official title of the Final Bill was changed from the Tax Cuts and Jobs Act to “The Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”
   i. On December 22, 2017, President Trump signed the Final Bill into law.

II. State Tax Conformity
   a. States generally fall within three regimes in terms of how they conform to the IRC:
      i. **Rolling Conformity** - states that adopt the provisions of the IRC in real time (“rolling” conformity states).
         1. For example, Maryland bases its corporate income tax on “the corporation’s federal taxable income for the taxable year as determined under the Internal Revenue Code ….” Md. Code Ann., Tax-Gen. § 10-304(1).
      ii. **Fixed-date Conformity** - states that conform to the IRC as of a static or fixed date (“fixed” conformity states). For example, until recently New Hampshire conformed to the IRC in effect as of December 31, 2000. N.H. Rev. Stat. Ann. section 77-A:1.XX.(1).
      iii. **Selective Conformity** - states that pick and choose different provisions of the IRC (“selective” conformity states). (*See, e.g.*, Ark. Code Ann. § 26-51-404 *et seq.*).
III. Significant Changes (Other than International Provisions)

a. Reduced Corporate Tax Rate (IRC § 11)
   i. The corporate tax rate is reduced from 35% to 21% for tax years beginning after December 17, 2017.
   ii. 80% and 70% DRDs are reduced to 65% and 50%, respectively, for tax years beginning after December 31, 2017 to reflect the lower corporate tax rate.
   iii. Georgia: HB 918 also lowers the top marginal income tax rate from 6% to 5.75% for 2019 with a provision for further reduction to 5.5% by 2020.

b. Elimination of the Corporate Alternative Minimum Tax (“AMT”) (previously IRC § 55)
   i. The corporate AMT is repealed for tax years beginning after December 31, 2017.
   ii. Georgia: this change would not affect Georgia taxable income.

c. Reduced Rate for Certain Pass-Through Income (IRC § 199)
   i. Generally allows a taxpayer other than a corporation to deduct 20% of the taxpayer’s “qualified business income” and certain other income (subject to limitation based on the type of business and the taxpayer’s taxable income for the tax year), resulting in a reduced effective rate of tax on such income.
   ii. Georgia: Georgia conforms to this change.

d. NOL Limitations
   i. For losses arising in tax years beginning after December 31, 2017, NOL deductions are limited to 80% of taxable income.
   ii. Unused NOLs may be carried forward indefinitely.
   iii. NOL carryforwards from prior years are not subject to the 80% limitation.
   iv. For losses arising in tax years beginning after December 31, 2017, the two-year carrybacks of NOLs is generally eliminated.
   v. Georgia: adopts the revised federal NOL deduction and carryforward rules.

e. Interest Limitation - Section 163(j)
   i. Limits the deduction for net business interest expense to 30% of adjusted taxable income
ii. Generally, disallowed business interest may be carried forward indefinitely.

iii. **Georgia:** conforms to this change to the interest limitation.

**f. Full Expensing for Five Years: IRC § 168(k)**

i. Expands bonus depreciation, permitting taxpayers to elect, on an asset-by-asset basis, to fully expense the cost of both new and used “qualified property” acquired and placed in service after September 27, 2017, and before January 1, 2023.

ii. **Georgia:** Georgia has traditionally decoupled from federal bonus depreciation continues to decouple from IRC § 168(k), including the new 100% bonus depreciation.

**g. Contributions to Capital - Section 118**

i. Former IRC §118 excluded from gross income “any contribution to the capital of the taxpayer.”

   1. This extended to contributions to capital made by persons other than shareholders, including contributions made by a “governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities.” Treas. Reg. §1.118-1.

ii. TCJA amended IRC §118 is amended to provide that the term “contribution to the capital of the taxpayer” does not include “any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).” H.R. 1, §13312; IRC §118(b)(2)(2018).

iii. Contributions of money or property to a corporation by a governmental entity will be includible in gross income (unless another exclusion applies).

iv. **Georgia:** decouples from this provision, so where a taxpayer may not exclude contributions for federal tax purposes, they may be excluded for computing Georgia tax.

**IV. International Provisions**

a. **Deemed Repatriation - IRC § 965**

i. One-time transition tax on untaxed foreign earnings of certain foreign subsidiaries of US companies by deeming those earnings to be repatriated

ii. Amounts are included in a taxpayer’s gross income as Subpart F income

iii. The amount taxed is determined based on foreign subsidiaries’ E&P, the greater amount measured on one of two testing dates.
iv. The tax rate on amounts attributable to cash and cash equivalents is 15.5%, and any remaining E&P is taxed at an 8% rate. Effective rates are achieved through a partial deemed DRD.

v. Tax may be paid in installments over an eight-year period.

vi. Georgia: Continues to exclude Subpart F Income.

b. Global Intangible Low Taxed Income (GILTI) - IRC § 951A
   i. Imposes tax on a US taxpayer’s Global Intangible Low Taxed Income (GILTI), which approximates the taxpayer’s allocable share of amounts earned by CFCs outside the US in excess of routine returns on tangible property.
   ii. Included in federal taxable income in a manner similar to Subpart F income.
   iii. A 50% deduction for such income is provided, generally resulting in a US tax rate of 10.5% for GILTI income, reduced by 80% of related foreign tax credits, subject to ordinary limitations.
   iv. Georgia: deducts GILTI income from Georgia taxable income, along with other subpart F income.

c. Foreign Derived Intangible Income (FDII) – IRC § 250
   i. Permits domestic corporations to deduct 37.5% of their Foreign Derived Intangible Income (FDII), which calculates an amount similar to GILTI and multiplies that amount by the fraction of the income earned in the US that is attributable to property sold or licensed to a non-US person for foreign use or to services provided outside the US.
   ii. Georgia: a Georgia taxpayer would be entitled to take into account the FDII deduction under IRC § 250 to the extent that the related income is taken into account in determining Georgia taxable income. Because Subpart F income is not included, the deduction would similarly not be applicable.

d. BEAT: IRC § 59A
   i. The BEAT applies to U.S. corporations (other than RICs, REITs, or S corporations), which have average annual gross receipts of at least $500 million for the preceding three tax years and which have a base erosion percentage (generally, deductible payments to foreign affiliates over total deductions) of 3% (2% for affiliated groups that include a bank or securities dealer) or higher for the tax year.
   ii. Generally imposes a 10% minimum tax (5% in 2018) on a taxpayer’s income determined without regard to tax deductions arising from base erosion payments.
iii. Base erosion payments: generally amounts paid by a taxpayer to a related foreign person that are deductible to the taxpayer (including interest) or that create depreciable or amortizable asset basis.

iv. Georgia: these new provisions do not impact Georgia taxable income.

V. Types of State Responses

a. State Conformity

i. Change in rates

1. The TCJA resulted in a federal tax cut for corporations of about 10 percent, but according to the COST/EY study on “The Impact of Federal Tax Reform on State Corporate Income Taxes” will result in an average state corporate tax base increase of about 12% (based on 2018 update and pre-federal tax reform (FTR) linkage to IRC).

2. This outcome is entirely inadvertent: If states conform mechanically to the TCJA, they will link to federal corporate base-broadening measures but not to federal corporate tax cuts.

ii. Interest Deduction Limitation. Section 163(j)

1. How do you determine the entity limitation?

2. Limitation calculated at the combined group level?

b. State Taxation of Foreign Source Income

i. States that do not otherwise provide for a DRD for foreign dividends received may also not conform to the new IRC § 245A or enact legislation to decouple

ii. SALT Implications vary based on whether the state conforms to subpart F.


1. In Kraft, the U.S. Supreme Court found that Iowa’s inclusion of dividends from foreign subsidiaries, but not from domestic subsidiaries, in a taxpayer’s apportionable income tax base unconstitutionally discriminated against foreign commerce. Iowa’s discrimination was based on the state’s conformity to the federal corporate income tax scheme, however, the Court held that “the Iowa statute cannot withstand scrutiny … for it facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause.”

2. Because the transition tax requires an inclusion with respect to foreign subsidiaries while there is not a similar income inclusion
with respect to domestic subsidiaries, a state’s conformity to the transition tax will likely face constitutional scrutiny under *Kraft*.

iv. Full Expensing. IRC § 168(k). Few because most states historically have “decoupled” from bonus depreciation.


i. Deemed Repatriation

<table>
<thead>
<tr>
<th>Types of State Responses</th>
<th>State</th>
<th>Language of Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selective conformity to section 965</td>
<td>ID</td>
<td>Effective January 1, 2017, conforms to IRC as in effect on December 21, 2017, and selectively updates conformity to section 965 as in effect on December 31, 2017</td>
</tr>
<tr>
<td>Section 965(a) amount included as exempt CFC Income</td>
<td>NY</td>
<td>Expands the definition of exempt CFC income under Article 9-A to include the federal repatriation amount calculated pursuant to section 965(a) (as adjusted by section 965(b) and without regard to section 965(c)) regardless of whether the shareholder conducts a unitary business with the CFC or CFCs</td>
</tr>
<tr>
<td>Section 965 amounts not included in state returns</td>
<td>DE, NC</td>
<td>Due to the mechanics of the state income tax forms, section 965 income does not appear on the state tax return</td>
</tr>
</tbody>
</table>

ii. GILTI

<table>
<thead>
<tr>
<th>Types of State Responses</th>
<th>Example State</th>
<th>Language of Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apply subtraction to GILTI</td>
<td>IL</td>
<td>“…the Illinois subtraction modification for foreign dividends will exclude a portion of the increase from Illinois base income” related to the GILTI inclusion</td>
</tr>
<tr>
<td>Apply subtraction to GILTI</td>
<td>GA</td>
<td>Georgia expanded the provision for the state’s subtraction for subpart F income to include “income specified in Section 951A of the Internal Revenue Code of 1986”</td>
</tr>
<tr>
<td>Exclude GILTI</td>
<td>WI</td>
<td>For Wisconsin tax purposes, conformity to the Internal Revenue Code does not include section 951A</td>
</tr>
<tr>
<td>Types of State Responses</td>
<td>Example State</td>
<td>Language of Response</td>
</tr>
<tr>
<td>--------------------------</td>
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</tr>
<tr>
<td>No legislation, but released administrative guidance treating GILTI as taxable</td>
<td>NY</td>
<td>“Although this new GILTI income is treated similarly to Subpart F income, it is specifically not characterized as Subpart F income under the IRC and therefore would not qualify as other exempt income. Thus, the income would flow through to New York, be treated as business income, and be subject to tax”</td>
</tr>
<tr>
<td>No legislation but released guidance that GILTI is deductible</td>
<td>KY</td>
<td>“For federal purposes, GILTI is treated similarly to Subpart F income, therefore, GILTI is considered nontaxable income for Kentucky income tax purposes”</td>
</tr>
</tbody>
</table>

d. Georgia  
i. HB 918 – Georgia’s annual IRC conformity bill this year took on more weight in light of federal tax reform. The legislation provides for general conformity with the Internal Revenue Code of 1986 as provided for in federal law enacted on or before February 9, 2018. HB 918 specifically provides that Georgia will decouple from the federal Tax Cuts and Jobs Act (TCJA) for the contributions of capital (IRC § 118), full expensing (IRC § 168) and the interest deduction limitation provisions (IRC § 163(j)). HB 918 also lowers the top marginal income tax rate from 6% to 5.75% for 2019 with a provision for further reduction to 5.5% by 2020. Act 284, H.B. 918, 154th Gen. Assem., Reg. Sess. (Ga. 2018) was signed by the Governor on March 2, 2018.

ii. SB 328 – After passage of HB 918, the General Assembly made a technical correction to decouple from the new federal taxation of Global Intangible Low Tax Income (“GILTI”). SB 328 treats GILTI as Subpart F income for purposes of the deduction under O.C.G.A. § 48-7-21(b)(8) and prevents Georgia from taxing the income of controlled foreign corporations owned by Georgia taxpayers. Therefore, all GILTI will be excluded from Georgia taxable income. Act 284, S.B. 328, 154th Gen. Assem., Reg. Sess. (Ga. 2018) was signed by the Governor on March 26, 2018.
Tax Policy


The state tax impact of recently enacted federal tax reform is still being assessed. In this article, Eversheds Sutherland (US) LLP’s Jeffrey A. Friedman, Todd G. Betor, and Michael S. Spencer discuss the impact of federal tax reform’s international tax provisions.

By Jeffrey A. Friedman, Todd G. Betor, and Michael S. Spencer

What may very well be the single most significant change in the last 30 years to state and local tax (“SALT”) across the United States was signed into law on December 22, 2017. It was not passed by any state legislature or signed by any state governor. Rather, President Trump’s signing of H.R. 1, popularly known as the Tax Cuts and Jobs Act (the “Act”) (The Act was formerly titled the “Tax Cuts and Jobs Act,” but the Senate parliamentarian ruled that the name violated Senate rules, forcing the name to be changed to the less catchy “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”), potentially sets in motion the most substantial overhaul of state tax codes in recent history. (Pub. L. 115-97, 131 Stat. 2054 (Dec. 22, 2017)). The Act proposes numerous changes to the Internal Revenue Code (“IRC”) (Unless otherwise stated, all references to the IRC shall mean the IRC as amended by the Act.) that likely will ultimately result in corresponding and collateral changes to most states’ tax codes.

Because of states’ broad conformity to the federal income tax laws (See, e.g., Jerome Hellerstein and Walter Hellerstein, State Taxation section 7.02 (3rd ed. 2001, with updates through December 2017)), many of these changes will have an impact on taxpayers’ SALT liabi-
ties. This article focuses on the SALT consequences stemming from the following provisions of the Act:

(i) a one-time “transition tax” on untaxed accumulated earnings and profits (“E&P”) of controlled foreign corporations (“CFC”) and certain other foreign corporations (the “Transition Tax”);

(ii) 100% dividends received deduction (“DRD”) for certain foreign source dividends;

(iii) current taxation of certain US taxpayer’s global intangible low-taxed income (“GILTI”);

(iv) deduction allowed to US taxpayers for foreign derived intangible income (“FDII”); and

(v) a base erosion and anti-abuse tax (“BEAT”) imposed on certain US taxpayers.

**Federal Tax Reform Cheat Sheet**

**Transition Tax**

(IRC §965)

- One-time transition tax on untaxed foreign earnings of certain foreign subsidiaries of US companies by deeming those earnings to be repatriated.
- Amounts are included in a taxpayer’s gross income as part F income.
- The amount taxed is determined based on foreign subsidiaries’ E&P, the greater amount measured on one of two testing dates.
- The tax rate on amounts attributable to cash and cash equivalents is 15.5%, and any remaining E&P is taxed at an 8% rate. These effective rates are achieved through a partial deemed DRD.
- Tax may be paid in installments over an 8-year period.

**Foreign DRD**

(IRC §245A)

- 100% DRD or “participation exemption” equal to the “foreign-source portion” of dividends a US taxpayer receives from a 10%-owned foreign corporation.

**GILTI**

(IRC §§951A, 250)

- Imposes tax on a US taxpayer’s Global Intangible Low Taxed Income (“GILTI”), which approximates the taxpayer’s allocable share of amounts earned by CFCs outside the US in excess of routine returns on tangible property.
- Included in federal taxable income in a manner similar to part F income.
- A 50% deduction for such income is provided, generally resulting in a US tax rate of 10.5% for GILTI income, reduced by 80% of related foreign tax credits, subject to ordinary limitations.

**FDII**

(IRC §250)

- Permits domestic corporations to deduct 37.5% of their Foreign Derived Intangible Income (“FDII”), which calculates an amount similar to GILTI and multiplies that amount by the fraction of the income earned in the US that is attributable to property sold or licensed to a non-US person for foreign use or to services provided outside the US.

**BEAT**

(IRC §§14401, 59A)

- The Base Erosion Anti-Abuse Tax (“BEAT”) generally imposes a 10% minimum tax (5% in 2018) on a taxpayer’s income determined without regard to tax deductions arising from base erosion payments (including the portion of a taxpayer’s net operating loss (“NOL”) deduction treated as related to base erosion payments), which generally cannot be reduced by credits other than, through 2025, the research credit under IRC §41(a) (“R&D credit”) and 80% of certain other credits.

**Interest Limitation**

(IRC §163(j))

- Limits the deduction for net business interest expense to 30% of adjusted taxable income.
- Generally, disallowed business interest may be carried forward indefinitely.

**Bonus Depreciation**

(IRC §168(k))

- Expands bonus depreciation to allow full expensing of the cost of both new and used “qualified property” acquired and placed in service after September 27, 2017, and before January 1, 2023.
- Phase out of depreciation rate for property placed in service between 2023 and 2026; zero rate in 2027 and thereafter.

**Much Ado About Conformity**

The gating question as to the SALT impact from the Act will be whether and how a state conforms to the IRC. States generally fall within three regimes in terms of how they conform to the IRC:

(1) states that adopt the provisions of the IRC in real time (“rolling” conformity states) (For example, Maryland bases its corporate income tax on “the corporation’s federal taxable income for the taxable year as determined under the Internal Revenue Code . . .”, Md. Code Ann., Tax-Gen. §10-304(1). See also, e.g., Del. Code Ann. 30 §1901(10), D.C. Code Ann. §47-1801.04(28), and Mass. Gen. Laws Ann. ch. 63, §§30(3), 30(4)).

(2) states that conform to the IRC as of a static or fixed date (“fixed” conformity states) (For example, until recently New Hampshire conformed to the IRC in effect as of December 31, 2000. N.H. Rev. Stat. Ann. section 77-A:1.XX.(1). See also, e.g., Fla. Stat. §220.03(1)(n), Ga. Code Ann. §48-1-2(14), and Va. Code Ann. §58.1-301(B)).

(3) states that pick and choose different provisions of the IRC (“selective” conformity states). (See, e.g., Ark. Code Ann. §26-51-404 et seq.)
Most states are split between rolling (approximately 22 states) (Alabama, Alaska, Colorado, Connecticut, Delaware, District of Columbia, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Missouri, Montana, Nebraska, New Mexico, New York (generally), North Dakota, Oklahoma, Oregon, Rhode Island, Tennessee, and Utah). For brevity, this article does not discuss the nuances of each state’s conforming provisions. and fixed (approximately 20 states) (Arizona, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Michigan (taxpayers may elect to apply the current IRC date), Minnesota, New Hampshire, North Carolina, Ohio (personal income tax), South Carolina, Texas, Vermont, Virginia, West Virginia, and Wisconsin.) conformity methods, with only a handful falling into selective conformity states (approximately 5 states). (Arkansas, California, Mississippi, New Jersey, and Pennsylvania.). Making matters more complicated, all states selectively “de-conform” from certain enumerated IRC provisions. For instance, many states have separately enacted net operating loss rules and dividers received deductions that are different from the IRC provisions. (See, e.g., 72 Pa. Stat. Ann. §§ 7401(3)(1)(m), 7501(c)(1)(A)(VIII) (requiring taxpayers to add back NOLs deducted under IRC § 172 on their federal return in calculating Pennsylvania taxable income and permitting taxpayers to deduct an amount of NOLs up to 35% of their taxable income for tax years starting after December 31, 2017, but before 2019); La. Rev. Stat. Ann. §§ 47:287.73(B)(1), 47:287.86 (requiring taxpayers to add back NOLs deducted under IRC § 172 on their federal return in calculating Louisiana taxable income and permitting taxpayers to subtract from Louisiana income an amount as its “net operating loss deduction,” not to exceed 72% of its Louisiana net income; with loss carryovers to each of the 20 taxable years following the taxable year of such loss); COMAR 03.04.03.07(A)(5) (preventing taxpayers from using an NOL generated when a corporation is not subject to Maryland income tax as a deduction to offset Maryland income in a carryover year); La. Rev. Stat. Ann. §§ 47:287.73(B)(3), 47:287.738(F)(1) (requiring taxpayers to add back the amounts of dividends received deductions allowed by IRC §§ 243, 244, and 245 and permitting taxpayers a deduction equal to 72% of the amount of dividends otherwise included in gross income for the period of July 1, 2015, though June 30, 2018, and a 100% percent deduction for all other periods beginning after December 31, 2005)).

It’s All About the [Tax] Base

The Transition Tax

The Transition Tax has the potential to significantly expand the federal income tax base for any corporation caught within the purview of IRC § 965. IRC § 965 provides for a one-time tax on a US shareholder with respect to its investment in CFCs and certain other foreign corporations based on those entities’ untaxed accumulated E&P. The untaxed accumulated E&P is divided into two categories: cash and non-cash amounts. The cash amounts are taxed at a 15.5% effective rate and non-cash amounts are taxed at an 8% effective rate.

Federal Mechanics

The Transition Tax operates within the framework of “subpart F” of the IRC. The subpart F rules generally require certain income earned by a CFC to be included in the gross income of a United States shareholder (“US shareholder”) (The Act revised the definition of US shareholder to include a US person (as defined in IRC § 7701(a)(30)) that owns, directly, indirectly or constructively, 10% or more of the vote or value of the stock of a foreign corporation. However, this change is made effective for tax years of foreign corporations beginning after December 31, 2017, and thus, does not apply for purposes of the Transition Tax. Accordingly, for purposes of the Transition Tax, US shareholder means a US person that owns, directly, indirectly or constructively, 10% or more of the vote of the stock of a foreign corporation., on a pro rata basis, whether or not the earnings are distributed to such US shareholders. (IRC § 951(a)(1)). A CFC is defined as any foreign corporation where more than 50% of its stock (either by vote or value) is owned directly or indirectly by US shareholders. (IRC §957(a)).

The Act requires a US shareholder of a “specified foreign corporation,” generally defined as any CFC or a foreign corporation with respect to which one or more domestic corporations is a US shareholder (each an “SFC”) (IRC §965(e)(1)), to include in gross income, as subpart F income, its post-1986 accumulated E&P. (The measurement date of a SFC’s untaxed accumulated E&P is either November 2, 2017 (the date the first version of the Act was introduced in the US House of Representatives) or December 31, 2017, whichever date on which there is a greater amount of E&P. IRC §965(a)). A US shareholder must then include its pro rata share of such amount as subpart F income in its taxable year within which the SFC’s last taxable year beginning before January 1, 2018 ends. (This is subject to any reduction – a netting – based on the US shareholder’s allocable share of the E&P deficits of any other SFCs. IRC §§951(a), 965(a), 965(b)(5)).

In order to achieve the effective rate on the two classes of E&P, a US shareholder is entitled to a deduction – analogous to a DRD – to achieve (i) a 15.5% effective rate on accumulated untaxed E&P up to the amount of cash and cash equivalents held by the relevant SFCs and (ii) an 8% effective rate on any remaining untaxed accumulated E&P (the “Transition Tax Deduction”). (IRC §965(c)). A US shareholder is permitted to apply foreign tax credits against its tax, but foreign tax credits related to the IRC §965 inclusion are only allowed in proportion to the previously untaxed E&P that is subject to tax after taking into account the related deduction. (IRC §965(g)).

A US shareholder may elect to pay the Transition Tax over eight years, paying 8% of the liability in each of the first five years, 15% in the sixth year, 20% in the seventh, and 25% in the eighth. (IRC §965(h)).

Transition Tax in the SALT World – A One-Time Windfall?

The state tax consequences of the Transition Tax will depend on whether a given state conforms to the Transition Tax, and whether the state conforms to the Transition Tax Deduction. While the Transition Tax amount will be included in federal taxable income, it is less clear how the Transition Tax Deduction will be incorpo-
rated into the Form 1120 federal tax return. Because some states compute taxable income beginning with either line 28 or line 30, the “geography” of where the Transition Tax Deduction will appear on the federal Form 1120 tax return is important. (Line 28 is federal taxable income before net operating loss deductions and special deductions. Thus, for a state that specifies the starting point for determining state taxable income as line 28, the amount will exclude, in addition to special deductions, a taxpayer’s net operating loss deductions).

We believe that the Transition Tax Deduction will most likely appear before line 28 of the Form 1120 federal tax return. The IRC describes special deductions as those deductions set forth in IRC §243 – 250. (The Internal Revenue Service, at times, has expanded what is included as “special deductions,” but these changes have not been through statute or regulation). The Transition Tax Deduction under IRC §965 should thus be taken prior to line 28, with conforming states including the Transition Tax Deduction in determining the starting point of a taxpayer’s state income tax base regardless of whether their starting point is line 28 or after.

How the Transition Tax impacts a taxpayer’s state income tax liability will also depend on whether states that include the Transaction Tax Deduction will enact a requirement to add-back the Transaction Tax Deduction. Since some states require the add-back of the federal DRD, it is possible that a state may likewise require the Transition Tax Deduction to be added back.

The state tax treatment of the Transition Tax may also be affected by a taxpayer’s state income tax filing method – worldwide combined, water’s-edge, or separate – and each state’s rules for the treatment of subpart F income. Absent statutory changes, a state that does not tax subpart F income will likely be unable to benefit from the Transition Tax. Other states break from the general subpart F rules, requiring taxpayers to make state specific calculations of taxable foreign earnings. For example, California does not conform to the federal treatment of subpart F income. Rather, California requires water’s-edge filers to include a portion of their CFC’s income in the water’s-edge return. (Cal. Rev. & Tax. Cdt. §25110(a)(2)(A)(ii). The CFC’s net income is multiplied by a ratio of its subpart F income for the taxable year to its E&P for the taxable year to arrive at the amount of CFC income that will be included in the combined report. Id. Thus, to the extent California – a selective conformity state – conforms to IRC §965, the amount of a CFC’s untaxed accumulated E&P for California purposes could be reduced by a portion of the amount taxed under the state’s CFC/subpart F regime. Because IRC §965 applies to non-CFCs, any reduction in the Transition Tax as a result of a CFC’s E&P being previously taxed by the state may not provide relief to all affected taxpayers. Like California, each state will have their own complexities as to how the Transition Tax will coordinate with their existing corporate income tax regimes. Given the speedy passage of the Act, it is likely that the states are still figuring out this very point.

Taxpayers will also need to be cognizant of the timing of state tax liability due to the Transition Tax compared to the federal elective deferred payment. While IRC §965 affords an election to pay the Transition Tax over a period of eight years, it does not delay the recognition of the income. Unless a state affords a similar deferral mechanism, taxpayers will have to currently recognize and take into income the net inclusion of a SFC’s untaxed accumulated E&P and Transition Tax Deduction. Additionally, some states do not allow the use of foreign tax credits in the calculation of state income tax liability. State disallowance of foreign tax credits provides another potential disconnect between the protections afforded for federal tax purposes under the Act and the resulting impact on state corporate income taxes.

**States Take Caution**

States implementing the mechanics of the Transition Tax should be cognizant of the restrictions announced in Kraft General Foods, Inc. v. Iowa Department of Revenue. 505 US 71, 112 S. Ct. 2365 (1992). In Kraft, the US Supreme Court found that Iowa’s inclusion of dividends from foreign subsidiaries, but not from domestic subsidiaries, in a taxpayer’s apportionable income tax base unconstitutionally discriminated against foreign commerce. Iowa’s discrimination was based on the state’s conformity to the federal corporate income tax scheme (See IRC §243, 901, 902), however, the Court held that “the Iowa statute cannot withstand scrutiny . . . for it facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause.” (Kraft Gen. Foods, Inc. v. Iowa Dept’l Revenue, 505 US 71, 82, 112 S. Ct. 2365 (1992)). Because the Transition Tax requires an inclusion with respect to foreign subsidiaries while there is not a similar income inclusion with respect to domestic subsidiaries, a state’s conformity to the Transition Tax will likely face constitutional scrutiny under Kraft.

Additionally, taxpayers may argue that the Transition Tax is unconstitutionally discriminatory because states would include in taxable income a form of foreign (deemed) dividends (i.e., subpart F income under IRC §965), but not include the corresponding apportionment factors of the SFC. Some taxpayers may thus argue that a pro rata share of an SFC’s apportionment factors, equal to the ratio used for the calculation of the Transition Tax, must be included in determining a taxpayer’s state income tax apportionment factors. Taxpayers have been unsuccessful, however, in making similar arguments in the context of foreign royalties and other foreign income. (See Caterpillar Fin. Servs., Inc. v. Whitley, 680 N.E.2d 1082 (Ill. 1997); In re Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993); Caterpillar, Inc. v. Commissioner of Revenue, 568 N.W.2d 695 (Minn. 1997), cert. denied, 522 US 112, 118 S. Ct. 1043 (1998); Caterpillar, Inc. v. New Hampshire Dep’t of Revenue Admin., 741 A.2d 56 (N.H. 1999), cert. denied, 529 US 1021, 120 S. Ct. 1424 (2000); cf. El Du Pont de Nemours & Co., 675 A.2d 82 (Me. 1996)).

**Foreign DRD**

Complementing the Transition Tax and the attempted shift to a federal territorial tax system, the Act creates a new section, IRC §245A, which provides a corporate US shareholder (generally, a 10% owner) (As discussed above, the Act has expanded the definition of a US shareholder to include any US person (individual or corporation) who directly or indirectly owns at least 10% of the voting power or value of the CFC’s stock. IRC §951(b). The Act also provides for more robust stock ownership attribution rules in determining
whether a US person is a US shareholder) with a 100% DRD or “participation exemption” equal to the "foreign-source portion" of any dividend it receives from a foreign corporation (the “Foreign DRD”). (IRC §245A. These amounts do not include dividends attributable to a “passive foreign investment company” as defined in IRC §1297). The Foreign DRD is not available with respect to dividends received by a US shareholder from a CFC if the dividends are deductible by the CFC in computing its taxes (i.e., hybrid dividends). In addition, no foreign tax credits are allowed for any taxes paid or accrued with respect to any dividend that qualifies for the Foreign DRD.

A move to a 100% DRD is nothing new for multinational corporate state taxpayers, because some states allow a 100% subtraction or DRD for foreign dividends. This treatment largely stems from the Kraft decision. (Kraft, 505 US 71 (1992)). Unlike the Transition Tax, the Foreign DRD falls within the IRC’s “special deductions.” Whether the starting point for calculating the state tax base is line 28 or a subsequent line of a corporation’s federal tax return Form 1120 is critical to determining the state impact of the Foreign DRD. States that do not otherwise provide for a DRD for foreign dividends received may also not conform to the new IRC §245A or enact legislation to decouple. However, as with the calculation of the Transition Tax, any differing treatment between domestic and foreign dividends will likely face constitutional scrutiny under Kraft.

**GILTI/FDII**

Global intangible low-taxed income (“GILTI”) is the “stick” to foreign-derived intangible income’s ("FDII") “carrot.” This article accordingly addresses these two provisions of the Act together. Because both GILTI and FDII are new sections of the IRC, taxpayers may see a disconnect at the state level. Without a state’s conformity to FDII, however, a state corporate taxpayer may be left licking their GILTI wounds.

**Federal Mechanics**

The Act, under new IRC §951A, generally imposes a current tax on a US shareholder’s GILTI computed as its share of its CFCs’ income in excess of a routine return on its US shareholder’s aggregate share of the CFCs’ depreciable tangible property. (IRC §§8951A(a), (b)). The GILTI tax operates by requiring a US shareholder to include in taxable income its GILTI in a manner similar to subpart F income inclusion. (IRC §951A(f)). While the Act requires the inclusion of GILTI, it also generally allows a 50% deduction for the GILTI under new IRC §250 (IRC §250(a)(1)), subject to a taxable income limitation on the amount of the deduction allowed. (IRC §250(a)(2)).

Specifically, if the sum of a domestic corporation’s FDII and GILTI amounts exceeds its taxable income determined without regard to IRC §250, then the amount of FDII and GILTI for which a deduction is allowed is reduced by an amount determined by such excess. (Id.). The inclusion of GILTI with the accompanying 50% deduction generally results in an effective US tax rate of 10.5% on GILTI, not taking into account foreign taxes. For taxable years beginning after December 31, 2025, the deduction is reduced to 37.5%, resulting in an effective tax rate of 13.125% on GILTI. (Id.). Taxpayers may also claim a foreign tax credit for 80% of foreign taxes paid on CFCs’ income that gives rise to the GILTI inclusion, which is in a separate category of income for foreign tax credit purposes and cannot be carried back or forward – e.g., use it or lose it. (IRC §960(d)). Therefore, the GILTI of a taxpayer that is able to utilize foreign tax credits generally will not be subject to residual US tax if the average foreign tax rate imposed on such income is at least 13.125%. For taxable years after December 31, 2025, the deduction is reduced to 37.5%. (IRC §250(a)(3)(B)).

In addition to the 50% GILTI deduction, new IRC §250 permits domestic corporations to deduct 37.5% of their FDII (Deemed intangible income multiplied by the fraction of foreign-derived deduction eligible income over deduction eligible income), which is income computed similar to GILTI and is attributable to certain sales of property to foreign persons or to the provision of certain services to any person, or with respect to any property, located outside the US. (IRC §250(a)(1)). The FDII provision generally results in a reduced effective tax rate of 13.125% on FDII (Id.), subject to a taxable income limitation on the amount of the deduction allowed. (IRC §250(a)(2)). For taxable years after December 31, 2025, the deduction is reduced to 21.875%. (IRC §250(a)(2)(A)).

**Broadening the SALT Base with a Stick**

The impact of the GILTI and FDII provisions on the state corporate income taxes of multinational corporations – should states conform – will generally be a broadening of the state tax base, unless an exclusion otherwise applies. Unlike the Transition Tax, the GILTI’s base broadening effect is not a one-time deal.

Because IRC §951A is a new section, states will not have a specific exclusion for GILTI. Likewise, the 50% GILTI deduction is contained in new IRC §250, which is included in the line 29b “special deductions.” The FDII deduction – the carrot – is also contained in IRC §250. Whether the starting point for calculating a state’s tax base is line 28 or a subsequent line of a corporation’s Form 1120 will therefore play a significant role in determining the state impact of the GILTI tax and FDII deduction. States may also fail to conform to IRC §250 deductions or may require the add-back of amounts deducted under IRC §250. The result would be a corporate taxpayer paying state tax on income that was offset by a corresponding deduction under federal law. The IRC §250 deductions, as a taxable income limitation, may also operate differently for state purposes because of the difference in tax base/consolidation for federal and state income tax purposes. Additionally, some states do not allow the use of foreign tax credits in the calculation of state income tax liability, further adding to the disconnect of the Act’s intended federal impact with state income tax results.

As with the Transition Tax, the impact of GILTI (and FDII) will be affected by a taxpayer’s state income tax filing method and state-specific rules for the treatment of subpart F income. States’ inclusion of GILTI, where there is not a similar income inclusion from domestic subsidiaries, may also run afoul of Kraft. And, like the Transition Tax, taxpayers may argue that the GILTI inclusion is unconstitutionally discriminatory because they are required to include a form of foreign (deemed) dividends (i.e., subpart F income under IRC §951A), but
do not include the CFC’s factors attributable to such income in the apportionment formula.

In addition, the inclusion of GILTI and/or the Transition Tax in calculating state taxable income will require taxpayers to review the application of, and impact to, state deductions and adjustments, including NOLs, tax credits, and state expense disallowance provisions.

**BEAT**

Included in the Act is a form of minimum tax – the base erosion and anti-abuse tax (“BEAT”) – with a stated goal of discouraging US corporations from the perceived erosion of the US tax base through deductible or amortizable payments to foreign affiliates.

**Federal Mechanics**

The Act, under new IRC §59A, applies BEAT to corporations which have annual gross receipts of at least $500 million for the preceding three taxable years and which have a base erosion percentage (i.e., generally deductible payments to foreign affiliates over total deductions), of at least 3% (2% for affiliated groups that include a bank or securities dealer). IRC §59A(e). The applicable gross receipts and base erosion percentage are determined using a special aggregation rule. IRC §59A(e)(3). In addition, special rules apply for determining the applicable gross receipts of a foreign person. IRC §59A(e)(2)(A). The BEAT imposes a 10% (5% in 2018) minimum tax on a taxpayer’s modified taxable income (“MTI”) to the extent such amount exceeds the taxpayer’s regular tax liability (as defined in IRC §26(b)) which generally cannot be reduced by credits other than, through 2025, the R&D credit and 80% of “applicable section 38 credits.” IRC §59A(b)(1). For this purpose, applicable IRC §38 credits include the low-income housing credit determined under IRC §42(a), the renewable electricity production credit determined under IRC §45(a), and the investment credit determined under IRC §46, but only to the extent properly allocable to the energy credit determined under IRC §48.

A taxpayer’s MTI is determined by adding back to a taxpayer’s adjusted taxable income the total deductions taken during the tax year arising from base erosion payments made to foreign affiliates without regard to tax deductions arising from the base erosion payments, including a proportionate amount of a taxpayer’s NOL. IRC §59A(c)(1)). Base erosion payments are generally defined as amounts paid by a taxpayer to a related foreign person that are deductible to the taxpayer or that create depreciable or amortizable asset basis. IRC §59A(d)(1)). Base erosion payments generally do not include payments for cost of goods sold, payments for certain services provided at cost, payments subject to US withholding tax (actually deducted and withheld), and payments with respect to certain derivatives. IRC §59A(d)). The base erosion percentage is relevant for determining not only whether a corporation is subject to the BEAT at all (which it is if the base erosion percentage is greater than 3%), but also to determine the degree to which NOL deductions are added back to MTI.

To show how the BEAT applies, take the following simple example. Assume that a multinational corporation (that satisfies the gross receipts threshold) for 2019 has $1,000 of gross income, $300 of deductible payments to a related foreign affiliate, $100 of deductible payments to an unrelated foreign party, and $200 NOL.

**First, calculate the taxpayer’s regular tax liability under IRC §26(b):**

- $1,000 – Gross income
- $(300) – Deductible payments to related foreign party (i.e., base erosion payments)
- $(100) – Deductible payments to unrelated foreign party (i.e., non-base erosion payments)
- $600 – Adjusted taxable income
- $(200) – NOL
- $400 – Taxable income
- X 21% (New corporate tax rate)

= $84 Regular corporate tax liability

**Second, calculate the taxpayer’s modified taxable income:**

- $400 – Taxable income is the starting point
- +$300 – Base erosion payments
- +$150 – Percentage of total NOL added back based on base erosion percentage ($200 x 75%)
- $850 – MTI

**Finally, calculate the base erosion minimum tax amount.**

Using these numbers the taxpayer’s base erosion minimum tax amount is $1 (10% x $850 MTI = $85 less $84 taxpayer’s regular corporate tax liability). In this example, the taxpayer would have a tax liability of $85, comprised of the $84 regular corporate tax liability plus the additional $1 of BEAT liability. (Because this example assumes no tax credits, the example is a shortcut for the for IRC §59A(b)(1)(B) calculation).

**We Got the BEAT?**

The federal impact of the BEAT is the payment of additional tax for those taxpayers subject to it. Because the BEAT is a separate tax that does not go into the calculation of federal taxable income, the BEAT currently does not have an impact on state taxable income. However, taxpayers should stay on the lookout for what states will do with the BEAT.

**Conclusion**

With the start of most state legislative sessions, state legislatures will likely grapple with how to handle the issues created by the Act. Taxpayers should stay abreast of these developments and be prepared to address the issues discussed herein and others that are sure to come. Unfortunately, it is unlikely that state guidance will come any time soon on how taxpayers are to comply with the new Act.
Recently enacted federal tax reform is expected to generate $6.5 billion in additional federal revenue through 2027 by increasing corporate tax liability for certain state and local incentives. In this article, Eversheds Sutherland (US) LLP’s Timothy A. Gustafson and Hanish S. Patel discuss the change and opportunities to minimize its impact.

**Many State Tax Incentives Are Now Taxable Due to Federal Tax Reform**

On December 22, 2017, the President signed into law H.R. 1, the bill formerly known as the Tax Cuts and Job Act (the “Act”), enacting the largest restructuring of the federal tax code since the Tax Reform Act of 1986. Pub. L. 115-97, 131 Stat. 2054 (Dec. 22, 2017). Among its sweeping reforms, the legislation contains a significant change to the treatment of certain incentives offered to corporate taxpayers by state and local governments. Specifically, a wide array of governmental incentives may now constitute taxable gross income to the recipient for federal income tax purposes. Taxpayers should consider these federal tax changes related to their existing and future state tax incentives, including cash grants, no-cost land or equipment, “public” infrastructure and improvements, or other similar transfers of money or property to a corporation.

**Contributions to Capital” Under Federal Law: Then to Now**

Gross income is defined broadly for federal tax purposes as all income from whatever source derived. Internal Revenue Code (“IRC”) §61(a). Generally, for corporations, former IRC §118 excluded from gross income “any contribution to the capital of the taxpayer.” IRC §118 (2017). Historically, this “contribution to capital” exclusion extended to contributions to capital made by persons other than shareholders, including contributions made by a “governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities.” Treas. Reg. §1.118-1. Therefore, if a contribution of money or property from a governmental entity constituted a “contribution to capital” under IRC...
§118(a), it was excluded from a corporate taxpayer’s gross income.

In U.S. v. Chicago, Burlington & Quincy R.R. Co. ("CB&Q"), 412 U.S. 401 (1973), the United States Supreme Court held that a corporate taxpayer’s receipt of a capital contribution from a non-shareholder must satisfy a five factor test in order for the contribution to be excluded from gross income under IRC §118(a). The five factors are:

1. The contribution must become a permanent part of the corporation’s working capital structure.
2. The payment cannot be in exchange for a direct benefit to the transferee, such as a payment for a service provided by the corporation.
3. The contribution must be bargained for.
4. The asset transferred must result in a benefit to the corporation in an amount commensurate with its value.
5. The contributed property ordinarily will be used in a manner that ultimately generates income for the corporation.

CB&Q, 412 U.S. at 413. Consequently, only those incentives that satisfied the five factors under CB&Q were excluded as a contribution to capital by a non-shareholder under former IRC §118. See, e.g., Sprint Nextel Corp. v. United States, 779 F. Supp. 2d 1184 (D. Kan. 2011) (holding payments from the Federal Communications Commission’s Universal Service Fund did not satisfy the test for exclusion as non-shareholder contributions to capital and, instead, constituted taxable supplements to gross income).

Under the Act, IRC §118 is amended to expressly provide that the term “contribution to the capital of the taxpayer” does not include “any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).” H.R. 1, §13312; IRC §118(b)(2) (2018). Accordingly, contributions of money or property to a corporation by a governmental entity will be includible in gross income (unless another exclusion applies). By its terms, the legislative amendments to IRC §118 apply “to contributions made after the enactment date” of the bill — i.e., contributions made after December 22, 2017. H.R. 1, §13312(b)(1). However, the amended IRC §118 will not apply to any contributions made by a governmental entity pursuant to a master development plan approved by that governmental entity prior to the enactment date. Id. §13312(b)(2).

Impact on Certain State and Local Incentives

According to the Joint Committee on Taxation, the new provision is estimated to generate approximately $6.5 billion between 2018 and 2027. This revenue increase is not surprising, considering that the new legislation will impact a broad range of state and local incentives that corporate recipients traditionally have not treated as taxable income for federal purposes. Most notably, the legislation would affect incentives such as cash grants, no-cost land, equipment, “public” infrastructure and improvements, reimbursements, refunds, or other similar transfers of money or property to a corporation.

To incent businesses to relocate or expand in a state, many states offer cash grants based on a project meeting certain employment or investment requirements. For example, Connecticut’s “First Five Program” offers grants to projects that are expected to create at least 200 new jobs and require an investment of $25 million. Conn. Gen. Stat. §32-41. Since 2012, total grants under the First Five Program have ranged between $8.5 to $48 million to various businesses, including manufacturing, media, and financial service companies. Under the new legislation, grants under the First Five Program may give rise to taxable income.

Similarly, many local governments offer land or public infrastructure improvements at no-cost as inducements to invest locally. For example, in 2012, local development authorities in Georgia offered hundreds of acres of land, as well as substantial road, water, and sewer improvements, to a heavy equipment manufacturer for locating a new manufacturing facility in the state. In total, the land and improvements were valued at approximately $20 million. Under the Act, the receipt of these types of grants from local development authorities could now be subject to federal income tax, depending on how the incentives are structured.

While the new provision applies to contributions made after the date of enactment, taxpayers with existing incentive agreements may still be affected. For example, a business may have an existing incentive agreement in 2016, but may not receive the underlying incentive until 2019. In such case, the contribution likely may be treated as having been made in 2019.

Looking Ahead

Generally, the receipt of state and local tax incentives such as state and local tax credits, deductions, abatements, rate reductions, and exemptions do not constitute taxable income for federal tax purposes. Instead, the Internal Revenue Service (“IRS”) (currently) views these incentives as a reduction (or potential reduction) in a taxpayer’s outstanding state or local tax liability. See, e.g., IRS NSAR 20085201F (Dec. 26, 2008) (treating receipt of Michigan state tax credit as reduction of business tax liability). Under the IRS’ view, tax credits may be treated as income if they are refundable or transferable, and to the extent the credits offset tax that was previously paid by the taxpayer and for which a federal tax deduction was claimed. Id.

Accordingly, there may be opportunities to restructure the receipt of an existing incentive to minimize the risk it will qualify as a taxable contribution under the new legislation. For example, a locality’s contribution of land at no-cost to a corporation very likely will be taxable, while a locality’s lease of land to the corporation, and corresponding abatement of any property taxes on the leasehold interest, likely would not be considered taxable income. Moreover, states and localities may respond to the amendments to IRC §118 by offering new credits, exemptions, and other incentives that would not be excluded from the definition of “contribution to capital”. Taxpayers would be wise to watch for any new offerings.

In addition to incentives from state and local governments, the legislation also will affect various incentives or grants from federal entities. As an example, in Revenue Ruling 93-16, 1993-1 C.B. 26, the IRS ruled that a grant by the Federal Aviation Administration (“FAA”) to a corporate owner of a public-use airport under the Airport Improvement Program was a nontaxable, non-shareholder contribution to the capital of the corpora-
tion under former IRC §118(a). However, under the Act, the grant now likely would be includible as gross income.

We also expect to see increased activity by the IRS in examining incentives and related contributions occurring prior to the change in law. As part of its Large Business & International (“LB&I”) Compliance Campaigns, and prior to the Act, the IRS announced a new initiative on “Economic Development Incentives” to ensure compliance with the IRC §118 exclusion. Press Release, IRS Announces Rollout of 11 Large Business and International Compliance Campaigns (Nov. 3, 2017). The LB&I Compliance Campaigns provide an overview of the issues where the IRS will be focusing its efforts. The LB&I Campaign on Economic Development Incentives suggests that the IRS will be focusing not only on the legislative change, but also on the legal sufficiency of exclusions under the former IRC §118. In addition, the IRS states that the compliance treatment for the campaign will be “issue based examination,” rather than soft letters, voluntary self-correction, practitioner outreach, or published guidance, suggesting a more active review of prior exclusions.

**Conclusion**

Although the ultimate impact of tax reform under the Act remains to be seen, the legislation will reduce the value of certain state and local incentives by including those incentives in federal taxable income. There are, however, opportunities to minimize the federal tax impact while maintaining the same net economic benefit of the particular incentive. In addition, taxpayers should re-examine their federal income tax treatment for incentives received in prior years to support exclusion under former IRC §118.
Senate Bill 328
By: Senators Albers of the 56th, Hufstetler of the 52nd, Cowsert of the 46th, Hill of the 4th, Watson of the 1st and others

AS PASSED

A BILL TO BE ENTITLED
AN ACT

To amend Article 2 of Chapter 7 of Title 48 of the Official Code of Georgia Annotated, relating to imposition, rate, computation, and exemptions from state income tax, so as to modify income taxation of corporations; to provide for the expiration of certain income tax credits; to provide for related matters; to provide for an effective date and applicability; to repeal conflicting laws; and for other purposes.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF GEORGIA:

SECTION 1.

Article 2 of Chapter 7 of Title 48 of the Official Code of Georgia Annotated, relating to imposition, rate, computation, and exemptions from state income tax, is amended in Code Section 48-7-21, relating to taxation of corporations, by revising subparagraph (b)(8)(A) as follows:

"(A) A corporation from sources outside the United States as defined in the Internal Revenue Code of 1986. For purposes of this subparagraph, dividends received by a corporation from sources outside of the United States shall include amounts treated as a dividend and income deemed to have been received under provisions of the Internal Revenue Code of 1986 by such corporation if such amounts could have been subtracted from taxable income under this paragraph, had such amounts actually been received but shall not include income specified in Section 951A of the Internal Revenue Code of 1986. The deduction provided by Section 250 shall apply to the extent the same income was included in Georgia taxable net income. The deduction, exclusion, or subtraction provided by Section 245A, Section 965, or any other section of the Internal Revenue Code of 1986 shall not apply to the extent income has been subtracted pursuant to this subparagraph. Amounts to be subtracted under this subparagraph shall include the following unless excluded by this paragraph, as defined by the Internal Revenue Code of 1986:

(i) Qualified electing fund income;
(ii) Subpart F income, including income specified in Section 951A of the Internal Revenue Code of 1986; and
(iii) Income attributable to an increase in United States property by a controlled foreign corporation.
The amount subtracted under this subparagraph shall be reduced by any expenses directly attributable to the dividend income; and”

SECTION 2.
Said article is further amended in Code Section 48-7-29.3, relating to income tax credits for federal qualified transportation fringe benefits, by adding a new subsection to read as follows:
"(e) This Code section shall stand repealed on December 31, 2018.”

SECTION 3.
Said article is further amended in Code Section 48-7-29.5, relating to income tax credits for private driver education courses, by adding a new subsection to read as follows:
"(f) This Code section shall stand repealed on December 31, 2018.”

SECTION 4.
Said article is further amended in Code Section 48-7-40.19, relating to income tax credits for diesel particulate emission reduction technology equipment, by adding a new subsection to read as follows:
"(e) This Code section shall stand repealed on December 31, 2018.”

SECTION 5.
This Act shall become effective upon its approval by the Governor or upon its becoming law without such approval and shall be applicable to all taxable years beginning on or after January 1, 2018.

SECTION 6.
All laws and parts of laws in conflict with this Act are repealed.
House Bill 918 (AS PASSED HOUSE AND SENATE)
By: Representatives Efstration of the 104th, Rogers of the 10th, Rhodes of the 120th, Powell of the 171st, Williamson of the 115th, and others

A BILL TO BE ENTITLED
AN ACT

To amend Title 48 of the Official Code of Georgia Annotated, relating to revenue and taxation, so as to define the terms "Internal Revenue Code" and "Internal Revenue Code of 1986" and thereby incorporate certain provisions of the federal law into Georgia law; to double the standard deduction amounts; to lower the personal and corporate income tax rates; to revise provisions relating to assignment of corporate income tax credits; to provide for no liability for state or local title ad valorem tax fees in a replacement title transaction for a vehicle not less than 15 years old; to provide for related matters; to provide for effective dates and applicability; to repeal conflicting laws; and for other purposes.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF GEORGIA:

PART I

SECTION 1-1.

Title 48 of the Official Code of Georgia Annotated, relating to revenue and taxation, is amended by revising paragraph (14) of Code Section 48-1-2, relating to definitions regarding revenue and taxation, as follows:

"(14) 'Internal Revenue Code' or 'Internal Revenue Code of 1986' means for taxable years beginning on or after January 1, 2016, the provisions of the United States Internal Revenue Code of 1986, as amended, provided for in federal law enacted on or before February 9, 2018, except that Section 85(c), Section 108(i), Section 163(e)(5)(F), Section 164(a)(6), Section 164(b)(6), Section 168(b)(3)(I), Section 168(e)(3)(E)(ix), Section 168(e)(3)(H), Section 168(e)(3)(B)(vi), Section 168(e)(8), Section 168(k) (but not excepting Section 168(k)(2)(A)(i), Section 168(k)(2)(D)(i), and Section 168(k)(2)(E)), Section 168(m), Section 168(n), Section 172(b)(1)(H), Section 172(b)(1)(J), Section 172(j), Section 179(d)(1)(B)(ii), Section 179(f), Section 199, Section 381(c)(20), Section 382(d)(3), Section 810(b)(4), Section 1400L, Section 1400N(d)(1), Section 1400N(f), Section 1400N(j), Section 1400N(k), and Section 1400N(o) of the Internal Revenue Code.
of 1986, as amended, shall be treated as if they were not in effect, and except that Section 168(e)(7), Section 172(b)(1)(F), and Section 172(i)(1), and Section 1221 of the Internal Revenue Code of 1986, as amended, shall be treated as they were in effect before the 2008 enactment of federal Public Law 110-343, and except that Section 163(i)(1) of the Internal Revenue Code of 1986, as amended, shall be treated as it was in effect before the 2009 enactment of federal Public Law 111-5, and except that Section 13(e)(4) of 2009 federal Public Law 111-92 shall be treated as if it was not in effect, and except that Section 118, Section 163(j), and Section 382(k)(1) of the Internal Revenue Code of 1986, as amended, shall be treated as they were in effect before the 2017 enactment of federal Public Law 115-97, and except that the limitations provided in Section 179(b)(1) shall be $250,000.00 for tax years beginning in 2010, shall be $250,000.00 for tax years beginning in 2011, shall be $250,000.00 for tax years beginning in 2012, shall be $250,000.00 for tax years beginning in 2013, and shall be $500,000.00 for tax years beginning in 2014, and except that the limitations provided in Section 179(b)(2) shall be $800,000.00 for tax years beginning in 2010, shall be $800,000.00 for tax years beginning in 2011, shall be $800,000.00 for tax years beginning in 2012, shall be $800,000.00 for tax years beginning in 2013, and shall be $2 million for tax years beginning in 2014, and provided that Section 1106 of federal Public Law 112-95 shall be treated as if it is in effect, except the phrase 'Code Section 48-2-35 (or, if later, November 15, 2015)’ shall be substituted for the phrase 'section 6511(a) of such Code (or, if later, April 15, 2015),' and notwithstanding any other provision in this title, no interest shall be refunded with respect to any claim for refund filed pursuant to Section 1106 of federal Public Law 112-95, and provided that subsection (b) of Section 3 of federal Public Law 114-292 shall be treated as if it is in effect, except the phrase 'Code Section 48-2-35' shall be substituted for the phrase 'section 6511(a) of the Internal Revenue Code of 1986' and the phrase 'such section' shall be substituted for the phrase 'such subsection.' In the event a reference is made in this title to the Internal Revenue Code or the Internal Revenue Code of 1954 as it existed on a specific date prior to January 1, 2017, February 9, 2018, the term means the provisions of the Internal Revenue Code or the Internal Revenue Code of 1954 as it existed on the prior date. Unless otherwise provided in this title, any term used in this title shall have the same meaning as when used in a comparable provision or context in the Internal Revenue Code of 1986, as amended. For taxable years beginning on or after January 1, 2016, 2017, provisions of the Internal Revenue Code of 1986, as amended, which were as of January 1, 2017, February 9, 2018, enacted into law but not yet effective shall become effective for purposes of Georgia taxation on the same dates upon which they become effective for federal tax purposes."
Said title is further amended by revising paragraph (1) of subsection (b) of Code Section 48-7-20, relating to individual income tax rates, as follows:

"(b)(1) The tax imposed pursuant to subsection (a) of this Code section shall be computed in accordance with the following tables:

**SINGLE PERSON**

<table>
<thead>
<tr>
<th>If Georgia Taxable Net Income Is:</th>
<th>The Tax Is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $750.00 ..........</td>
<td>1%</td>
</tr>
<tr>
<td>Over $750.00 but not over $2,250.00</td>
<td>$7.50 plus 2% of amount over $750.00</td>
</tr>
<tr>
<td>Over $2,250.00 but not over $3,750.00</td>
<td>$37.50 plus 3% of amount over $2,250.00</td>
</tr>
<tr>
<td>Over $3,750.00 but not over $5,250.00</td>
<td>$82.50 plus 4% of amount over $3,750.00</td>
</tr>
<tr>
<td>Over $5,250.00 but not over $7,000.00</td>
<td>$142.50 plus 5% of amount over $5,250.00</td>
</tr>
<tr>
<td>Over $7,000.00 .................</td>
<td>$230.00 plus 6% 5.75% of amount over $7,000.00</td>
</tr>
</tbody>
</table>

**MARRIED PERSON FILING A SEPARATE RETURN**

<table>
<thead>
<tr>
<th>If Georgia Taxable Net Income Is:</th>
<th>The Tax Is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $500.00 .................</td>
<td>1%</td>
</tr>
<tr>
<td>Over $500.00 but not over $1,500.00</td>
<td>$5.00 plus 2% of amount over $500.00</td>
</tr>
<tr>
<td>Over $1,500.00 but not over $2,500.00</td>
<td>$25.00 plus 3% of amount over $1,500.00</td>
</tr>
<tr>
<td>Over $2,500.00 but not over $3,500.00</td>
<td>$55.00 plus 4% of amount over $2,500.00</td>
</tr>
<tr>
<td>Over $3,500.00 but not over $5,000.00</td>
<td>$95.00 plus 5% of amount over $3,500.00</td>
</tr>
<tr>
<td>Over $5,000.00 ...................</td>
<td>$170.00 plus 6% 5.75% of amount over $5,000.00</td>
</tr>
</tbody>
</table>
HEAD OF HOUSEHOLD AND MARRIED PERSONS
FILING A JOINT RETURN

If Georgia Taxable
Net Income Is:
The Tax Is:
Not over $1,000.00 .......................... 1%
Over $1,000.00 but not over $3,000.00 ........ $10.00 plus 2% of amount over $1,000.00
Over $3,000.00 but not over $5,000.00 ....... $50.00 plus 3% of amount over $3,000.00
Over $5,000.00 but not over $7,000.00 ...... $110.00 plus 4% of amount over $5,000.00
Over $7,000.00 but not over $10,000.00 ...... $190.00 plus 5% of amount over $7,000.00
Over $10,000.00 .......................... $340.00 plus 6% 5.75% of amount over $10,000.00

SECTION 1-3.
Said title is further amended by revising paragraph (1) of subsection (b) of Code Section 48-7-20, relating to individual income tax rates, as follows: 
"(b)(1) The tax imposed pursuant to subsection (a) of this Code section shall be computed in accordance with the following tables:

SINGLE PERSON

If Georgia Taxable
Net Income Is:
The Tax Is:
Not over $750.00 .......................... 1%
Over $750.00 but not over $2,250.00 ........ $7.50 plus 2% of amount over $750.00
Over $2,250.00 but not over $3,750.00 ....... $37.50 plus 3% of amount over $2,250.00
Over $3,750.00 but not over $5,250.00 ...... $82.50 plus 4% of amount over $3,750.00
Over $5,250.00 but not over $7,000.00 ...... $142.50 plus 5% of amount over $5,250.00

H. B. 918
- 4 -
<table>
<thead>
<tr>
<th>Net Income Range</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over $7,000.00 ........................................</td>
<td>$230.00 plus 5.75% of amount over $7,000.00</td>
</tr>
</tbody>
</table>

**MARRIED PERSON FILING A SEPARATE RETURN**

<table>
<thead>
<tr>
<th>Net Income Range</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $500.00 .......................................</td>
<td>1%</td>
</tr>
<tr>
<td>Over $500.00 but not over $1,500.00 ....................</td>
<td>$5.00 plus 2% of amount over $500.00</td>
</tr>
<tr>
<td>Over $1,500.00 but not over $2,500.00 ...............</td>
<td>$25.00 plus 3% of amount over $1,500.00</td>
</tr>
<tr>
<td>Over $2,500.00 but not over $3,500.00 ...............</td>
<td>$55.00 plus 4% of amount over $2,500.00</td>
</tr>
<tr>
<td>Over $3,500.00 but not over $5,000.00 ...............</td>
<td>$95.00 plus 5% of amount over $3,500.00</td>
</tr>
<tr>
<td>Over $5,000.00 ..........................................</td>
<td>$170.00 plus 5.75% of amount over $5,000.00</td>
</tr>
</tbody>
</table>

**HEAD OF HOUSEHOLD AND MARRIED PERSONS FILING A JOINT RETURN**

<table>
<thead>
<tr>
<th>Net Income Range</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $1,000.00 .....................................</td>
<td>1%</td>
</tr>
<tr>
<td>Over $1,000.00 but not over $3,000.00 ...............</td>
<td>$10.00 plus 2% of amount over $1,000.00</td>
</tr>
<tr>
<td>Over $3,000.00 but not over $5,000.00 ...............</td>
<td>$50.00 plus 3% of amount over $3,000.00</td>
</tr>
<tr>
<td>Over $5,000.00 but not over $7,000.00 ...............</td>
<td>$110.00 plus 4% of amount over $5,000.00</td>
</tr>
<tr>
<td>Over $7,000.00 but not over $10,000.00 .............</td>
<td>$190.00 plus 5% of amount over $7,000.00</td>
</tr>
<tr>
<td>Over $10,000.00 .........................................</td>
<td>$340.00 plus 5.75% of amount over $10,000.00</td>
</tr>
</tbody>
</table>

H. B. 918  
- 5 -
SECTION 1-4.

Said title is further amended by revising subsection (a) of Code Section 48-7-21, relating to taxation of corporations, as follows:

"(a) Every domestic corporation and every foreign corporation shall pay annually an income tax equivalent to 5.75 percent of its Georgia taxable net income. Georgia taxable net income of a corporation shall be the corporation's taxable income from property owned or from business done in this state. A corporation's taxable income from property owned or from business done in this state shall consist of the corporation's taxable income as defined in the Internal Revenue Code of 1986, with the adjustments provided for in subsection (b) of this Code section and allocated and apportioned as provided in Code Section 48-7-31."

SECTION 1-5.

Said title is further amended by revising subsection (a) of Code Section 48-7-21, relating to taxation of corporations, as follows:

"(a) Every domestic corporation and every foreign corporation shall pay annually an income tax equivalent to 5.75 percent of its Georgia taxable net income. Georgia taxable net income of a corporation shall be the corporation's taxable income from property owned or from business done in this state. A corporation's taxable income from property owned or from business done in this state shall consist of the corporation's taxable income as defined in the Internal Revenue Code of 1986, with the adjustments provided for in subsection (b) of this Code section and allocated and apportioned as provided in Code Section 48-7-31."

SECTION 1-6.

Said title is further amended by revising subparagraphs (b)(8)(A) and (b)(10.1)(A) of Code Section 48-7-21, relating to taxation of corporations, as follows:

"(A) A corporation from sources outside the United States as defined in the Internal Revenue Code of 1986. For purposes of this subparagraph, dividends received by a corporation from sources outside of the United States shall include amounts treated as a dividend and income deemed to have been received under provisions of the Internal Revenue Code of 1986 by such corporation if such amounts could have been subtracted from taxable income under this paragraph, had such amounts actually been received but shall not include income specified in Section 951A of the Internal Revenue Code of 1986. The deduction provided by Section 250 shall apply to the extent the same income was included in Georgia taxable net income. The deduction, exclusion, or subtraction provided by Section 245A, Section 965, or any other section of the Internal Revenue Code of 1986 shall not include income specified in Section 951A of the Internal Revenue Code of 1986."
Revenue Code of 1986 shall not apply to the extent income has been subtracted pursuant to this subparagraph. Amounts to be subtracted under this subparagraph shall include the following unless excluded by this paragraph, as defined by the Internal Revenue Code of 1986:

(i) Qualified electing fund income;

(ii) Subpart F income; and

(iii) Income attributable to an increase in United States property by a controlled foreign corporation.

The amount subtracted under this subparagraph shall be reduced by any expenses directly attributable to the dividend income; and"

"(A) For any taxable year in which the taxpayer takes a federal net operating loss deduction on its federal income tax return, the amount of such deduction shall be added back to federal taxable income, and Georgia taxable net income for such taxable year shall be computed from the taxpayer's federal taxable income as so adjusted. There shall be allowed as a separate deduction from Georgia taxable net income so computed an amount equal to the aggregate of the Georgia net operating loss carryovers to such year, plus the Georgia net operating loss carrybacks to such year if such carrybacks are allowed by the Internal Revenue Code of 1986. Any limitations included in the Internal Revenue Code of 1986 on the amount of net operating loss that can be used in a taxable year shall be applied for purposes of this Code section; provided, however, that such limitations, including, but not limited to, the 80 percent limitation, shall be applied to Georgia taxable net income;"

SECTION 1-7.

Said title is further amended by revising paragraph (1) of subsection (a) of Code Section 48-7-27, relating to computation of taxable income of individuals, to read as follows:

"(1) Either the sum of all itemized nonbusiness deductions used in computing federal taxable income if the taxpayer used itemized nonbusiness deductions in computing federal taxable income or, if the taxpayer could not or did not itemize nonbusiness deductions, then a standard deduction as provided for in the following subparagraphs:

(A) In the case of a single taxpayer or a head of household, $2,300.00 $4,600.00;

(B) In the case of a married taxpayer filing a separate return, $1,500.00 $3,000.00;

(C) In the case of a married couple filing a joint return, $2,000.00 $6,000.00;

(D) An additional deduction of $1,300.00 for the taxpayer if the taxpayer has attained the age of 65 before the close of the taxpayer's taxable year. An additional deduction of $1,300.00 for the spouse of the taxpayer shall be allowed if a joint return is made by
the taxpayer and the taxpayer's spouse and the spouse has attained the age of 65 before the close of the taxable year; and

(E) An additional deduction of $1,300.00 for the taxpayer if the taxpayer is blind at the close of the taxable year. An additional deduction of $1,300.00 for the spouse of the taxpayer shall be allowed if a joint return is made by the taxpayer and the taxpayer's spouse and the spouse is blind at the close of the taxable year. For the purposes of this subparagraph, the determination of whether the taxpayer or the spouse is blind shall be made at the close of the taxable year except that, if either the taxpayer or the spouse dies during the taxable year, the determination shall be made as of the time of the death;”

SECTION 1-8.

Said title is further amended by adding a new paragraph to subsection (b) of Code Section 48-7-27, relating to computation of taxable income of corporations, to read as follows:

"(14) Georgia net operating losses shall be treated in the same manner as provided in paragraph (10.1) of subsection (b) of Code Section 48-7-21 but shall be based on the income as computed pursuant to this Code section. Any limitations included in the Internal Revenue Code of 1986 on the amount of net operating loss that can be used in a taxable year shall be applied for purposes of this Code section; provided, however, that such limitations, including, but not limited to, the 80 percent limitation, shall be applied to Georgia taxable net income."

SECTION 1-9.

Said title is further amended by revising subsection (c) and adding a new subsection to Code Section 48-7-42, relating to affiliated entities and assignment of corporate income tax credits, to read as follows:

"(c) The recipient of a tax credit assigned under subsection (b) of this Code section shall attach a statement to its return identifying the assignor of the tax credit, in addition to providing any other information required to be provided by a claimant of the assigned tax credit. With the exception of the transferable credits in Code Sections 48-7-29.8, 48-7-29.12, 48-7-40.26, and 48-7-40.26A, the recipient of a tax credit assigned under subsection (b) of this Code section shall also be eligible to take any credit against payments due under Code Section 48-7-103, subject to the same requirements as the assignor of such credit at the time of the assignment.”

"(g) For the purposes of all credits provided for by this chapter, the sale, merger, acquisition, or bankruptcy of any taxpayer shall not create new eligibility for the succeeding transferee in such transaction or event, but any unused credit eligible to be
applied against income tax liability under this article may be transferred and continued by
such transferee and applied against the transferee's income tax liability under this article.”

PART II
SECTION 2-1.

Said title is further amended in Chapter 5C, relating to the alternative ad valorem tax on
motor vehicles, by revising paragraph (15) of subsection (d) of Code Section 48-5C-1,
relating to definitions, exemption from taxation, allocation and disbursement of proceeds
collected by tag agents, fair market value of vehicle appealable, and report, as follows:
"(15) There shall be no liability for any state or local title ad valorem tax fees in any of
the following title transactions:
(A) The addition or substitution of lienholders on a motor vehicle title so long as the
owner of the motor vehicle remains the same;
(B) The acquisition of a bonded title by a person or entity pursuant to Code Section
40-3-28 if the title is to be issued in the name of such person or entity;
(C) The acquisition of a title to a motor vehicle by a person or entity as a result of the
foreclosure of a mechanic's lien pursuant to Code Section 40-3-54 if such title is to be
issued in the name of such lienholder;
(D) The acquisition of a title to an abandoned motor vehicle by a person or entity
pursuant to Chapter 11 of Title 40 if such person or entity is a manufacturer or dealer
of motor vehicles and the title is to be issued in the name of such person or entity;
(E) The obtaining of a title to a stolen motor vehicle by a person or entity pursuant to
Code Section 40-3-43;
(F) The obtaining of a title by and in the name of a motor vehicle manufacturer,
licensed distributor, licensed dealer, or licensed rebuilder for the purpose of sale or
resale or to obtain a corrected title, provided that the manufacturer, distributor, dealer,
or rebuilder shall submit an affidavit in a form promulgated by the commissioner
attesting that the transfer of title is for the purpose of accomplishing a sale or resale or
to correct a title only;
(G) The obtaining of a title by and in the name of the holder of a security interest when
a motor vehicle has been repossessed after default in accordance with Part 6 of Article
9 of Title 11 if such title is to be issued in the name of such security interest holder;
(H) The obtaining of a title by a person or entity for purposes of correcting a title,
changing an odometer reading, or removing an odometer discrepancy legend, provided
that, subject to subparagraph (F) of this paragraph, title is not being transferred to
another person or entity; and
(I) The obtaining of a title by a person who pays state and local title ad valorem tax fees on a motor vehicle and subsequently moves out of this state but returns and applies to retile such vehicle in this state; and

(J) The obtaining of a replacement title on a vehicle that is not less than 15 years old upon sufficient proof provided to the commissioner that such title no longer exists.”

PART III
SECTION 3-1.

(a) Sections 1-1, 1-6, and 1-8 of this Act shall become effective upon the approval of this Act by the Governor or upon this Act becoming law without such approval and such sections shall be applicable to all taxable years beginning on or after January 1, 2017.

(b) Sections 1-2 and 1-4 of this Act shall become effective upon the approval of this Act by the Governor or upon this Act becoming law without such approval and shall be applicable to all taxable years beginning on or after January 1, 2019. Sections 1-2 and 1-4 of this Act shall expire by operation of law on the last moment of December 31, 2025, and revert to the language of paragraph (1) of subsection (b) of Code Section 48-7-20 and subsection (a) of Code Section 48-7-21, respectively, as they existed on the day immediately preceding the effective date of this Act.

(c) Sections 1-3 and 1-5 of this Act shall become effective upon passage of a joint resolution that is signed by the Governor ratifying such sections by both houses of the Georgia General Assembly on or after January 13, 2020, and upon such passage shall be applicable to all taxable years beginning on or after January 1, 2020. Should Sections 1-3 and 1-5 of this Act become effective as prescribed in the foregoing, both sections shall expire by operation of law on the last moment of December 31, 2025, and revert to the language of paragraph (1) of subsection (b) of Code Section 48-7-20 and subsection (a) of Code Section 48-7-21, respectively, as they existed on the day immediately preceding the effective date of this Act.

(d) Section 1-7 of this Act shall become effective upon the approval of this Act by the Governor or upon this Act becoming law without such approval and shall be applicable to all taxable years beginning on or after January 1, 2018. Section 1-7 of this Act shall expire by operation of law on the last moment of December 31, 2025, and revert to the language of paragraph (1) of subsection (a) of Code Section 48-7-27 as it existed on the day immediately preceding the effective date of this Act.

(e) Section 1-9 of this Act shall become effective upon the approval of this Act by the Governor or upon this Act becoming law without such approval. The revisions to subsection (c) of Code Section 48-7-42 contained in Section 1-9 of this Act shall be applicable to tax credits that are assigned in taxable years beginning on or after January 1,
2018. New subsection (g) of Code Section 48-7-42 contained in Section 1-9 of this Act shall be applicable to sales, mergers, acquisitions, or bankruptcies occurring in taxable years beginning on or after January 1, 2018.

(f) Part II of this Act shall become effective July 1, 2018.

(g) Part III of this Act shall become effective upon its approval by the Governor or upon becoming law without such approval.

SECTION 3-2.

All laws and parts of laws in conflict with this Act are repealed.
A corporate taxpayer challenged the constitutionality of Iowa's income tax scheme. The Iowa Supreme Court, 465 N.W.2d 664, found that the income tax scheme which allowed deduction for dividends received from domestic subsidiaries but not for dividends received from foreign subsidiaries was constitutional. Certiorari was granted. The Supreme Court, Justice Stevens, held that the Iowa statute, which treated dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries, facially discriminated against foreign commerce in violation of the foreign commerce clause.

Reversed and remanded.

Chief Justice Rehnquist filed a dissenting opinion in which Justice Blackmun joined.

**2366 Syllabus**

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See United States v. Detroit Lumber Co., 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

*71 The Iowa statute that imposes a business tax on corporations uses the federal tax code's definition of “net income” with certain adjustments. Like the federal scheme, Iowa allows corporations to take a deduction for dividends received from domestic, but not foreign, subsidiaries. However, unlike the federal scheme, Iowa does not allow a credit for taxes paid to foreign countries. Petitioner Kraft General Foods, Inc., a unitary business with operations in the United States and several foreign countries, deducted its foreign subsidiary dividends from its taxable income on its 1981 Iowa return, notwithstanding the contrary provisions of Iowa law. Respondent Iowa Department of Revenue and Finance (Iowa) assessed a deficiency, which Kraft challenged in administrative proceedings and subsequently in Iowa courts. The Iowa Supreme Court rejected Kraft's argument that the disparate treatment of domestic and foreign subsidiary dividends violated the Commerce Clause of the Federal Constitution, holding that Kraft failed to demonstrate that the taxing scheme gave Iowa businesses a commercial advantage over foreign commerce.

Held: The Iowa statute facially discriminates against foreign commerce in violation of the Foreign Commerce Clause. It is indisputable that the statute treats dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries by including the former, but not the latter, in taxable income. None of the several arguments made by Iowa and its amici—that, since a corporation's domicile does not necessarily establish that it is engaged in either foreign or domestic commerce, the disparate treatment is not discrimination based on the business activity's location or nature; that a taxpayer can avoid the discrimination by changing a subsidiary's domicile from a foreign to a domestic location; that the statute does not treat Iowa subsidiaries more favorably than those located elsewhere; that the benefit to domestic subsidiaries might be offset by the taxes imposed on them by other States and the Federal Government; and that the statute is intended to promote administrative convenience rather than economic protectionism—justifies Iowa's differential treatment of foreign commerce. Pp. 2368–2372.

465 N.W.2d 664 (Iowa 1991), reversed and remanded.

*72 STEVENS, J., delivered the opinion of the Court, in which WHITE, O'CONNOR, SCALIA, KENNEDY, SOUTER, and THOMAS, JJ., joined. REHNQUIST, C.J., filed a dissenting opinion, in which BLACKMUN, J., joined, post, p. 2372.
Kraft General Foods, Inc. v. Iowa Dept. of Revenue and Finance, 505 U.S. 71 (1992)
112 S.Ct. 2365, 120 L.Ed.2d 59, 60 USLW 4582

Attorneys and Law Firms

Jerome B. Libin argued the cause for petitioner. With him on the briefs were Kathryn L. Moore and John V. Donnelly.

Marcia Mason, Assistant Attorney General of Iowa, argued the cause for respondent. With her on the brief were Bonnie J. Campbell, Attorney General, and Harry M. Griger, Special Assistant Attorney General.

Kent L. Jones argued the cause for the United States as amicus curiae urging affirmance. With him on the brief were Solicitor General Starr, Acting Assistant Attorney General Bruton, Deputy Solicitor General Wallace, Gary R. Allen, and Ernest J. Brown.*


Richard Ruda, Michael G. Dzialo, Martin Lobel, and James F. Flug filed a brief for the National Conference of State Legislatures et al. as amici curiae urging affirmation.

Opinion

Justice STEVENS delivered the opinion of the Court.

In 1981 petitioner Kraft General Foods, Inc. (Kraft), operated a unitary business throughout the United States and in several foreign countries. Because part of its business was conducted in Iowa, Kraft was subject to the Iowa Business Tax on Corporations. 1 At issue in this case is Iowa's inclusion in the tax base of the dividends that Kraft received from six subsidiaries, each of which was incorporated and conducted its business in a foreign country. 2 While Iowa taxes *73 the dividends that a corporation receives from its foreign subsidiaries, Iowa does not tax dividends received from domestic subsidiaries. The question presented is whether the disparate treatment of dividends from foreign and from domestic subsidiaries violates the Foreign Commerce Clause. 3

1 Iowa Code § 422.32 et seq. (1981).

See App. to Pet. for Cert. 29a. Kraft owned capital stock representing more than 80% of the voting power and of the total value of the subsidiaries. Ibid.

“The Congress shall have Power ... To regulate Commerce with foreign Nations...” U.S. Const., Art. I, § 8.

1

The Iowa statute uses the federal definition of “net income” with certain adjustments. 4 For federal tax purposes, corporations are generally allowed a deduction for dividends received from domestic subsidiaries. 5 As the earnings of the domestic subsidiaries, themselves, are subject to federal taxation, this deduction avoids a second federal tax on those earnings. 6 The Federal Government generally does not tax the earnings of foreign subsidiaries, and the dividends paid by foreign subsidiaries are not deductible. The parent corporation, however, does receive a credit for the foreign taxes paid on the dividends and on the underlying foreign earnings. 7 Like the deduction for domestic subsidiary dividends, the foreign tax credit is intended to mitigate multiple taxation of corporate earnings. 8


7 See 26 U.S.C. §§ 901, 902. Instead of taking the credit, the corporation may elect to deduct the foreign tax withheld on dividends from foreign subsidiaries. See § 164. The taxpayer may not take both the credit and the deduction. See § 275(a)(4). The credit is almost always more valuable to the taxpayer. See 3 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts ¶ 69.14 (2d ed. 1991).

In following the federal scheme for the calculation of taxable income, Iowa allows a deduction for dividends received from domestic subsidiaries, but not for those received from foreign subsidiaries. Iowa does not directly tax the income of a subsidiary unless the subsidiary, itself, does business in Iowa. Thus, if a domestic subsidiary transacts business in Iowa, its income is taxed, but if it does not do business in Iowa, neither its income nor the dividends paid to its parent are taxed. In the case of the foreign subsidiary doing business abroad, Iowa does not tax the corporate income, but does tax the dividends paid to the parent. Unlike the Federal Government, Iowa does not allow a credit for taxes paid to foreign countries. See 465 N.W.2d 664, 665 (Iowa 1991).

Iowa is not a State that taxes an apportioned share of the entire income of a unitary business, without regard for formal corporate lines. See Tr. of Oral Arg. 37; cf. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164–169, 103 S.Ct. 2933, 2939–2942, 77 L.Ed.2d 545 (1983). At oral argument, counsel for Kraft offered the following illustration: “If an Iowa parent company had a Kentucky subsidiary, [that] did all its business in Kentucky, and another subsidiary that did all its business in Germany, Iowa would not tax the income of either of those subsidiaries. If each paid a dividend to the Iowa parent, Iowa would tax the German dividends and would not tax the Kentucky dividends.” Tr. of Oral Arg. 47–48.

If in calculating its federal tax liability, a taxpayer elects to deduct foreign tax withheld on foreign subsidiary dividends, a taxpayer may also deduct these tax payments in calculating its Iowa taxes. Electing the deduction, then, allows the taxpayer to reduce, but not eliminate, the Iowa tax on foreign subsidiary dividends. In the relevant year, Kraft elected to take the foreign tax credit, see 465 N.W.2d, at 666, and thus could not deduct the foreign taxes in computing its federal or Iowa taxable income, see n. 7, supra.

In computing its taxable income on its 1981 Iowa return, Kraft deducted foreign subsidiary dividends, notwithstanding contrary provisions of Iowa law. Respondent Iowa Department of Revenue and Finance (Iowa) assessed a deficiency. After its administrative protest was denied, Kraft challenged the assessment in Iowa courts, alleging that the disparate treatment of domestic and foreign subsidiary dividends violated the Commerce Clause and the Equal Protection Clause of the Federal Constitution. The Iowa Supreme Court rejected the Commerce Clause claim because petitioner failed to demonstrate “that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme.” Id., at 668. In considering Kraft's challenge under the Equal Protection Clause, the court found that Iowa's use of the federal formula for calculation of taxable income was convenient both for the taxpayer and for the State. Concluding that the Iowa statute was rationally related to the goal of administrative efficiency, the Iowa Supreme Court held that the statute did not violate equal protection. Id., at 669. We granted certiorari. 502 U.S. 1056, 112 S.Ct. 931, 117 L.Ed.2d 103 (1992).

The principal dispute between the parties concerns whether, on its face, the Iowa statute discriminates against foreign commerce. It is indisputable that the Iowa statute treats dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries. Iowa includes the former, but not the latter, in the calculation of taxable income. While admitting that the two kinds of dividends are treated differently, Iowa and its amici advance several arguments in support of the proposition that this differential treatment does not constitute prohibited discrimination against foreign commerce.

Amicus United States notes that a subsidiary's place of incorporation does not necessarily correspond to the locus of its business operations. A domestic corporation might do business abroad, and its dividends might reflect earnings from its foreign activity. Conversely, a foreign corporation might do business in the United States, with its dividend payments reflecting domestic business operations. On this basis, the United States
 contends that the disparate treatment of dividends from foreign and domestic subsidiaries does not translate into discrimination based on the location or nature of business activity and is thus not prohibited by the Commerce Clause.

We recognize that the domicile of a corporation does not necessarily establish that it is engaged in either foreign or domestic commerce. In this case, however, it is stipulated that the foreign subsidiaries did, in fact, operate in foreign commerce and, further, that the decision to do business abroad through foreign subsidiaries is typically supported by legitimate business reasons. By its nature, a unitary business is characterized by a flow of value among its components. See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178, 103 S.Ct. 2933, 2947, 77 L.Ed.2d 545 (1983). The flow of value between Kraft and its foreign subsidiaries clearly constitutes foreign commerce; this flow includes the foreign subsidiary dividends, which, as Iowa acknowledges, themselves constitute foreign commerce.

The parties stipulated as follows:

“Domestic Corporations typically do business in foreign countries through corporations organized in the country in which they are doing business for a variety of reasons. Reasons include, but are not limited to, the requirements of the local country, a better ability to limit their liability in that country, the marketing advantage of being perceived by customers as a local company, greater ease in repatriating funds, greater ease in borrowing funds locally, and ability to own property and manufacture in that country.” App. to Pet. for Cert. 30a–31a.

Moreover, through the interplay of the federal and Iowa tax statutes, the applicability of the Iowa tax necessarily depends not only on the domicile of the subsidiary, but also on the location of the subsidiary’s business activities. The Federal Government generally taxes the income that a foreign corporation earns in the United States. In avoiding multiple taxation, the Government allows a deduction for foreign subsidiary dividends that reflect such domestic earnings. In adopting the federal pattern, Iowa also allows a deduction for dividends received from a foreign subsidiary if the dividends reflect business activity in the United States. Accordingly, while the dividends of all domestic subsidiaries are excluded from the Iowa tax base, the dividends of foreign subsidiaries are excluded only to the extent they reflect domestic earnings. In sum, the only subsidiary payments taxed by Iowa are those reflecting the foreign business activity of foreign subsidiaries. We do not think that this discriminatory treatment can be justified on the ground that some of the (untaxed) dividend payments from domestic subsidiaries also reflect foreign earnings.

18 See § 245.
19 The dissent presents the example of a subsidiary incorporated in a foreign country, but engaged in business exclusively in the United States. The dissent doubts whether a dividend payment from such a subsidiary is properly characterized as “foreign commerce.” Post, at 2373–2374. As discussed above, however, a dividend payment from such a subsidiary would not be taxed by Iowa. Iowa taxes foreign subsidiary dividends only to the extent that they reflect foreign earnings. The dissent does not dispute that this kind of dividend payment does constitute “foreign commerce.” Post, at 2373.

In a related argument, Iowa and amicus United States assert that Kraft could conduct its foreign business through domestic subsidiaries instead of foreign subsidiaries or, alternatively, could set up a domestic company to hold the stock of the foreign subsidiaries and receive the foreign dividend payments. In either case, Kraft, itself, would receive no dividends from foreign subsidiaries and would thus avoid paying Iowa tax on income attributable to the foreign operations. Iowa and the United States contend that these alternatives further demonstrate that it is not foreign commerce, but, at most, a particular form of corporate organization that is burdened.

This argument is not persuasive. Whether or not the suggested methods of tax avoidance would be practical as a business matter, and whether or not they might generate adverse tax consequences in other jurisdictions, we do not think that a State can force a taxpayer to conduct its foreign business through a domestic subsidiary in order to avoid discriminatory taxation of foreign commerce. Cf. Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 878–879, 105 S.Ct. 1676, 1681–1682, 84 L.Ed.2d 751 (1985). We have previously found
that the Commerce Clause is not violated when the
differential tax treatment of two categories of companies
"results solely from differences between the nature of
their businesses, not from the location of their activities."
_Amerada Hess Corp. v. Director, Div. of Taxation, N.J.
Dept. of Treasury_, 490 U.S. 66, 78, 109 S.Ct. 1617,
1624, 104 L.Ed.2d 58 (1989). We find no authority
for the different proposition advanced here that a tax
that does discriminate against foreign commerce may
be upheld if a taxpayer could avoid that discrimination
by changing the domicile of the corporations through
which it conducts its business. Our cases suggest the
contrary. See _Westinghouse Electric Corp. v. Tully_, 466
U.S. 388, 406, 104 S.Ct. 1856, 1867, 80 L.Ed.2d 388 (1984);
_Halliburton Oil Well Cementing Co. v. Reily_, 373 U.S. 64,
72, 83 S.Ct. 1201, 1205, 10 L.Ed.2d 202 (1963).

In _Amerada Hess_, we rejected the contention that
a New Jersey tax violated the Commerce Clause
because it "discriminate[d] against oil producers who
market their oil in favor of independent retailers who
do not produce oil." 490 U.S., at 78, 109 S.Ct., at
1624.

Repeating the argument that prevailed in the Iowa
Supreme Court, Iowa next insists that its tax system
does not violate the Commerce Clause because it does
dnot favor local interests. To the extent corporations do
business in Iowa, an apportioned share of their entire
corporate income is subject to Iowa tax. In the case of
a foreign subsidiary doing business abroad, Iowa would
tax the dividends paid to the domestic parent, but would
not tax the subsidiary's earnings. *79 Summarizing this
analysis, Iowa asserts: "More earnings of the domestic
subsidiary, which has income producing activities in Iowa,
than earnings of the foreign subsidiary, which has no
Iowa activities, are included in the preapportioned net
income base for the unitary business as a whole." Brief for
Respondent 19. Far from favoring local commerce, Iowa
argues, the tax system places additional burdens on Iowa
businesses.

We agree that the statute does not treat Iowa subsidiaries
more favorably than subsidiaries located elsewhere. We
are not persuaded, however, that such favoritism is an
essential element of a violation of the Foreign Commerce
Clause. In _Japan Line, Ltd. v. County of Los Angeles_,
441 U.S. 434, 99 S.Ct. 1813, 60 L.Ed.2d 336 (1979),
we concluded that the constitutional prohibition against
state taxation of foreign commerce is broader than the
protection afforded to interstate commerce, _id._, at 445–
446, 99 S.Ct., at 1819–1820, in part because matters of
concern to the entire Nation are implicated, _id._, at 448–
451, 99 S.Ct., at 1821–1823. Like the Import–Export
Clause, *21 the Foreign Commerce Clause recognizes
that discriminatory treatment of foreign commerce may
create problems, such as the potential for international
retaliation, that concern the Nation as a whole. _Id._,
at 450, 99 S.Ct., at 1822. So here, we think that a
State's preference for domestic commerce over foreign
commerce is inconsistent with the Commerce Clause even
if the State's own economy is not a direct beneficiary
of the discrimination. As the absence of local benefit
does not eliminate the international implications of the
discrimination, it cannot exempt such discrimination from
Commerce Clause prohibitions.

21 "No State shall, without the Consent of the
Congress, lay any Imposts or Duties on Imports or
Exports, except what may be absolutely necessary for
executing its inspection Laws..." U.S. Const., Art. I,
§ 10, cl. 2.

Iowa and _amicus_ United States also assert the stronger
claim that Iowa's tax system does not favor business
activity in the United States generally over business
activity abroad. If true, this would indeed suggest that
the statute does not *80 discriminate against foreign
commerce. We are not convinced, however, that this
description adequately characterizes the relevant features
of the Iowa statute. It is true that if a subsidiary **2371
were located in another State, its earnings would be
subject to taxation by the Federal Government and by
the other State (assuming that the State was one of the
great majority that impose a corporate income tax). **22
This state and federal tax burden might exceed the sum
of the foreign tax that a foreign subsidiary would pay and the
tax that Iowa collects on dividends received from a foreign
subsidiary. But whatever the tax burdens imposed by the
Federal Government or by other States, the fact remains
that _Iowa_ imposes a burden on foreign subsidiaries that
it does not impose on domestic subsidiaries. *23 We have
no reason to doubt the assertion of the United States that
"[i]n evaluating the alleged facial discrimination effected
by the Iowa tax, it is not proper to ignore the operation of
other *81 provisions of the same statute." Brief for
United States as _Amicus Curiae_ 14, n. 19 (emphasis
added). We find no authority, however, for the principle
that discrimination against foreign commerce can be
justified if the benefit to domestic subsidiaries might happen to be offset by other taxes imposed not by Iowa, but by other States and by the Federal Government.

22 Corporate income is taxed by 45 States and by the District of Columbia. See I J. Hellerstein, State Taxation: Corporate Income and Franchise Taxes ¶ 1.6 (1983).

23 If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent. In considering claims of discriminatory taxation under the Commerce Clause, however, it is necessary to compare the taxpayers who are “most similarly situated.” Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64, 71, 83 S.Ct. 1201, 1205, 10 L.Ed.2d 202 (1963). A corporation with a subsidiary doing business in Iowa is not situated similarly to a corporation with a subsidiary doing business abroad. In the former case, the Iowa operations of the subsidiary provide an independent basis for taxation not present in the case of the foreign subsidiary. A more appropriate comparison is between corporations whose subsidiaries do not do business in Iowa.

Finally, Iowa insists that even if discrimination against foreign commerce does result, the statute is valid because it is intended to promote administrative convenience rather than economic protectionism. Iowa contends that the adoption of the federal definition of “taxable income,” which includes foreign subsidiary dividends, provides significant advantages both to the taxpayers and to the taxing authorities. Taxpayers may compute their Iowa tax easily based on their federal calculations, and the Iowa authorities may rely on federal regulations and interpretations and may take advantage of federal efforts to monitor taxpayer compliance. See 465 N.W.2d, at 669.

We do not minimize the value of having state forms and auditing procedures replicate federal practice. Absent a compelling justification, however, a State may not advance its legitimate goals by means that facially discriminate against foreign commerce. See Philadelphia v. New Jersey, 437 U.S. 617, 626–628, 98 S.Ct. 2531, 2536–2538, 57 L.Ed.2d 475 (1978); Maine v. Taylor, 477 U.S. 131, 148, n. 19, 106 S.Ct. 2440, 2453, n. 19, 91 L.Ed.2d 110 (1986). In this instance, Iowa could enjoy substantially the same administrative benefits by utilizing the federal definition of taxable income, while making adjustments that avoid the discriminatory treatment of foreign subsidiary dividends. Many other States have adopted this approach. 24 It is apparent, then, that this is not a case in which the State's goals “cannot be adequately served by reasonable nondiscriminatory alternatives.” New Energy Co. of Indiana v. Limbach, 486 U.S. 269, 278, 108 S.Ct. 1803, 1810, 100 L.Ed.2d 302 (1988). Even if such adjustments would diminish the administrative benefits of adopting federal definitions, this marginal loss in convenience would not constitute the kind of serious health and safety concern that we have sometimes found sufficient to justify discriminatory state legislation. Cf. Maine v. Taylor, 477 U.S., at 151, 106 S.Ct., at 2454; Sporhase v. Nebraska ex rel. Douglas, 458 U.S. 941, 956–957, 102 S.Ct. 3456, 3464–3465, 73 L.Ed.2d 1254 (1982).

24 See App. to Pet. for Cert. 74a–75a.

**III**

Iowa need not adopt the federal definition of taxable income. Nor, having chosen to follow the federal system in part, must Iowa duplicate that scheme in all respects. The adoption of the federal system in whole or in part, however, cannot shield a state tax statute from Commerce Clause scrutiny. The Iowa statute cannot withstand this scrutiny, for it facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause. 25

25 Having concluded that the Iowa statute violates the Foreign Commerce Clause, we do not reach Kraft's challenge to the statute under the Equal Protection Clause.

The judgment of the Supreme Court of Iowa is reversed, and the case is remanded for further proceedings not inconsistent with this opinion.

It is so ordered.
Chief Justice REHNQUIST, with whom Justice BLACKMUN joins, dissenting.

Petitioner in this case limits its Commerce Clause challenge to a single argument—that Iowa's taxing scheme unconstitutionally discriminates against foreign commerce. It has brought a facial challenge to the Iowa taxing scheme. The burden on one making a facial challenge to the constitutionality of a statute is heavy; the litigant must show that "no set of circumstances exists under which the Act would be valid. The fact that [the tax] might operate unconstitutionally under some conceivable set of circumstances is *83 insufficient to render it wholly invalid." United States v. Salerno, 481 U.S. 739, 745, 107 S.Ct. 2095, 2100, 95 L.Ed.2d 697 (1987).

The only case dealing with the Foreign Commerce Clause substantially relied on by the Court in its opinion upholding petitioner's challenge to the Iowa statute is Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 99 S.Ct. 1813, 60 L.Ed.2d 336 (1979). It is important, therefore, to note how different are the facts in that case from those in the present one. In Japan Line, California had levied a nondiscriminatory ad valorem property tax on cargo containers which were owned by Japanese shipping companies based in Japan, had their home ports in Japan, and were used exclusively in foreign commerce. The containers were physically present in California for a fractional part of the year, but only as a necessary incident of their employment in foreign commerce. Japan levied no tax on similarly situated property of United States shipping companies.

In Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983), where we upheld a California franchise tax against a claim of violation of the Foreign Commerce Clause, we noted at least two distinctions between that case and our earlier decision in Japan Line. First, the tax there imposed was not on a foreign entity, but on a domestic corporation. Second, the United States did not file a brief urging that the tax be struck down. 463 U.S., at 196, 103 S.Ct., at 2956. In the present case, like Container Corporation, the Iowa tax is imposed on a domestic corporation, not on a foreign entity. And in the present case, the Executive Branch has not merely remained neutral, as it did in Container Corporation, but has filed a brief urging that the tax be sustained against the Foreign Commerce Clause challenge.

The Court agrees that the Iowa tax involved here does not favor subsidiaries incorporated in Iowa over foreign subsidiaries, but **2373 points out that the tax does favor subsidiaries incorporated in other States over foreign subsidiaries. Iowa obviously has no selfish motive to accomplish such a result, *84 and the absence of such a motive is strong indication that none of the local advantage which has so often characterized our Commerce Clause decisions is sought here. See, e.g., Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 268, 104 S.Ct. 3049, 3053, 82 L.Ed.2d 200 (1984). Indeed, petitioner carries on operations in Iowa, where the “State's own political processes [can] serve as a check against unduly burdensome regulations.” Kassel v. Consolidated Freightways Corp. of Del., 450 U.S. 662, 675, 101 S.Ct. 1309, 1319, 67 L.Ed.2d 580 (1981).

But assuming that it is sufficient to show simply that non-Iowa domestic “commerce” enjoys a benefit not enjoyed by foreign “commerce,” the Court surely errs in concluding that such a showing has been made in the present case. Because petitioner has chosen to make a facial challenge to the Iowa statute, the record is largely devoid of any evidence to suggest that Iowa's taxing scheme systematically works to discourage foreign commerce to the advantage of its domestic counterpart.

Petitioner's failures in this respect are severalfold. First, it is unclear on the present record what amount of foreign commerce is affected by the Iowa statute. The difficulty flows from our inability to make any useful generalizations about a corporation's business activity based solely on the corporation's country of incorporation. The Court recognizes that, in this era of substantial international trade, it is simple-minded to assume that a corporation's foreign domicile necessarily reflects that it is principally, or even substantially, engaged in foreign commerce. Ante, at 2368–2369. To the contrary, foreign domiciled corporations may engage in little or even zero foreign activity. In such cases, the suggestion that Iowa's tax has any real effect on foreign commerce is absurd; petitioner certainly has not demonstrated "by 'clear and cogent evidence' that [the state tax] results in extraterritorial values being taxed" in all cases. Franchise Tax Bd., supra, 463 U.S., at 175, 103 S.Ct., at 2945. In turn, Iowa's tax can hardly be
found to always unconstitutionally discriminate against foreign commerce. Given that petitioner's burden is to demonstrate \*85 that there are no circumstances in which Iowa's statute could be constitutionally applied, the existence of such a possibility should be fatal to petitioner's chances of success in this case.

The Court suggests that, even if foreign domiciled corporations are involved in no foreign trade, the dividend payments from subsidiary to parent are themselves "foreign commerce." Ante, at 2369. Again, this may be true in certain circumstances, as the payment of a dividend may represent a real flow of capital across international boundaries. But certainly there are other situations where the "foreign" aspects of a transaction are extraordinarily attenuated, and any burdening of such transactions concomitantly would not raise Foreign Commerce Clause concerns. Consider, for example, the case of a "foreign" subsidiary—\*86 i.e., one that is incorporated in a foreign country—but with operations exclusively in the United States. It has no assets in the foreign country, no operations, nothing of value whatsoever. The corporation declares a dividend payable to its United States parent. The payment in such circumstance may well be accomplished simply by debiting one New York bank account and crediting another. To characterize this as "foreign commerce" seems to me to stretch that term beyond all recognition. And again, the existence of such a possibility is sufficient to undermine petitioner's facial challenge.

The Court appears to think these problems are surmounted by the parties' stipulation that petitioner's subsidiaries operated in "foreign commerce" and that foreign subsidiaries are often established for legitimate business reasons. Ibid. Of course, a stipulation between parties cannot bind this Court \*2374 on a question of law. Moreover, even the facts that the stipulation establishes are sparse. It tells us nothing about the ratio in modern commerce of "real" foreign subsidiaries to their domestically oriented cousins. Indeed, on the present record it is impossible even to establish the scope of operation of Kraft's subsidiaries. Compare App. to Pet. for Cert. 52a–53a (reporting foreign tax payments \*86 by 6 of petitioner's subsidiaries) with id., at 76a–79a (listing petitioner's 86 nonwholly owned subsidiaries). Without some greater detail, I think it is impossible to conclude that the Iowa taxing scheme would have such real and substantial effects that it could never survive constitutional muster.

Finally, I cannot agree that, even if the dividend payments made taxable by the Iowa scheme are foreign commerce, that Iowa impermissibly discriminates against such payments. To be sure, two Iowa corporations, one with a foreign subsidiary and one with a domestic non-Iowa subsidiary will in some cases pay a different total tax. But this does not constitute unconstitutional discrimination because, as far as the record demonstrates, Iowa's taxing scheme does not result in foreign commerce being systematically subject to higher tax burdens than domestic commerce. Given that 45 of 50 States tax corporations on their net income, ante, at 2371, n. 22, in deciding to tax only a foreign subsidiary's dividend payments, rather than the subsidiary's total income, Iowa assures that the subsidiary's tax burden is less than that faced by its domestic counterpart. The deduction that Iowa extends to domestically based dividend payments simply helps to avoid what would otherwise be the near certainty that the domestic income would be doubly taxed—once when earned as income by the subsidiary and a second time when paid to the parent corporation.

But Iowa's attempt to take account of this near certainty with respect to domestic earnings does not in turn require it to make a similar assumption with respect to income earned by foreign sources. As amicus United States correctly points out, "[t]he record in this case fails to indicate even the existence, much less the nature, of such local-level foreign taxes.... Nor is there any evidence to reflect the credits or reductions that foreign local governments would apply or allow." Brief for United States as Amicus Curiae 15, n. 21.

\*87 Finally, as I would reject petitioner's Foreign Commerce Clause claim, I must go on to consider whether its Equal Protection Claim fares any better. It does not. In defending a tax classification such as this, a State need only demonstrate that the classification is rationally related to legitimate state purposes. Exxon Corp. v. Eagerton, 462 U.S. 176, 195, 103 S.Ct. 2296, 2308, 76 L.Ed.2d 497 (1983). The statute will be upheld if it could reasonably be concluded "that the challenged classification would promote a legitimate state purpose." Id., at 196, 103 S.Ct. at 2308. Administrative efficiency is certainly a legitimate state interest and Iowa's reliance
The Georgia legislative session concluded on March 29, 2018. In addition to two major bills relating to federal tax reform, Georgia enacted several other pieces of notable tax legislation.

Income Tax

HB 918 – IRC Conformity. Georgia's annual IRC conformity bill this year took on more weight in light of federal tax reform. The legislation provides for general conformity with the Internal Revenue Code of 1986 as provided for in federal law enacted on or before February 9, 2018. HB 918 specifically provides that Georgia will decouple from the federal Tax Cuts and Jobs Act (TCJA) for the contributions of capital (IRC § 118), full expensing (IRC § 168) and the interest deduction limitation provisions (IRC § 163(j)). HB 918 also lowers the top marginal income tax rate from 6% to 5.75% for 2019 with a provision for further reduction to 5.5% by 2020.

SB 328 – GILTI Not Taxable in Georgia. After passage of HB 918, the General Assembly made a technical correction to decouple from the new federal taxation of Global Intangible Low Tax Income (“GILTI”). SB 328 treats GILTI as Subpart F income for purposes of the deduction under O.C.G.A. § 48-7-21(b)(8) and prevents Georgia from taxing the income of controlled foreign corporations owned by Georgia taxpayers. Therefore, all GILTI will be excluded from Georgia taxable income. See more coverage here.

Sales Tax

HB 61 – Remote Sellers. HB 61 changes the definition of a “dealer” required to collect tax by creating a bright-line nexus rule for any seller that has either more than $250,000 of Georgia revenue or 200 separate sales of tangible personal property, delivered physically or electronically in Georgia within the current or previous calendar year. Sellers meeting this threshold must collect sales tax or submit to certain reporting requirements. This bill becomes effective January 1, 2019, by which point the US Supreme Court presumably will have ruled on the currently pending Wayfair case, which challenges the constitutionality of a similar South Dakota statute.

Eversheds Sutherland Observation: HB 61 includes sales of “tangible personal property” delivered electronically towards the nexus threshold. However, Georgia exempts electronically delivered computer software (as broadly defined) from sales and use tax. O.C.G.A. § 48-8-3(91). Georgia has also defined the sale of computer software electronically delivered as “intangible,” not tangible personal property. See Ga. Comp. R. & Reg. § 560-12-2-111(4).

HB 61 also provides a procedural mechanism for the Department of Revenue (“Department”) to enforce this provision by seeking a declaratory judgment from Related People/Contributors

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The Georgia legislative session concluded on March 29, 2018. In addition to two major bills relating to federal tax reform, Georgia enacted several other pieces of notable tax legislation.1

**Income Tax**

**HB 918 – IRC Conformity.**2 Georgia’s annual IRC conformity bill this year took on more weight in light of federal tax reform. The legislation provides for general conformity with the Internal Revenue Code of 1986 as provided for in federal law enacted on or before February 9, 2018. HB 918 specifically provides that Georgia will decouple from the federal Tax Cuts and Jobs Act (TCJA) for the contributions of capital (IRC § 118), full expensing (IRC § 168) and the interest deduction limitation provisions (IRC § 163(j)). HB 918 also lowers the top marginal income tax rate from 6% to 5.75% for 2019 with a provision for further reduction to 5.5% by 2020.

**SB 328 – GILTI Not Taxable in Georgia.**3 After passage of HB 918, the General Assembly made a technical correction to decouple from the new federal taxation of Global Intangible Low Tax Income (“GILTI”). SB 328 treats GILTI as Subpart F income for purposes of the deduction under O.C.G.A. § 48-7-21(b)(8) and prevents Georgia from taxing the income of controlled foreign corporations owned by Georgia taxpayers. Therefore, all GILTI will be excluded from Georgia taxable income. See more coverage [here](#).

**Sales Tax**

**HB 61 – Remote Sellers.** HB 61 changes the definition of a “dealer” required to collect tax by creating a bright-line nexus rule for any seller that has either more than $250,000 of Georgia revenue or 200 separate sales of tangible personal property, delivered physically or electronically in Georgia within the current or previous calendar year. Sellers meeting this threshold must collect sales tax or submit to certain reporting requirements. This bill becomes effective January 1, 2019, by which point the US Supreme Court presumably will have ruled on the currently pending *Wayfair* case,4 which challenges the constitutionality of a similar South Dakota statute.

**Eversheds Sutherland Observation:** HB 61 includes sales of “tangible personal property” delivered electronically towards the nexus threshold. However, Georgia exempts electronically delivered computer software (as broadly defined) from sales and use tax. O.C.G.A. § 48-8-3(91). Georgia has also defined the sale of computer software electronically delivered as “intangible,” not tangible personal property. See Ga. Comp. R. & Reg. § 560-12-2-.111(4).

HB 61 also provides a procedural mechanism for the Department of Revenue (“Department”) to enforce this provision by seeking a declaratory judgment from
superior court, with a direct appeal to the Georgia Supreme Court.

**HB 696 – Data Center Exemption.** HB 696 adds a new sales tax exemption for “high-technology data centers” that meet the minimum investment threshold. The minimum threshold is the creation of 20 new “quality jobs” and a minimum investment over a seven-year consecutive period of between $100 million to $250 million (depending on the population of the county in which the data center is located). A high-technology data center receiving the sales tax exemption is not eligible for the quality jobs income tax credits.

**Eversheds Sutherland Observation:** This new exemption is separate from and broader than the existing high-technology equipment exemption (O.C.G.A. § 48-8-3(68)), which exempts purchases of equipment by qualifying high-technology companies spending more than $15 million in a calendar year.

**HB 811 – Data Analytics Confidentiality Exemption.** HB 811 amends Georgia’s tax confidentiality statute (O.C.G.A. § 48-2-15) to add an exception to allow the Department to share confidential taxpayer information with “data analytics services” to assist the Department in identifying taxpayers that are non-compliant with Georgia sales & use tax law. This exception authorizes the Department to compensate such data analytics services on a “contingency basis” for the amount of revenue they help collect. Thus, for the first time, the Department would be authorized to use a third party for audit selection services, and to pay such services on a contingency basis.

**Eversheds Sutherland Observation:** Although it is not clear how data analytics services will earn contingency payments, the authorization of audit selection services receiving contingency payments may be inconsistent with other Georgia policy and law. The Georgia Supreme Court has held that a county’s contract with auditors on a contingency basis is void because it violates public policy. Moreover, O.C.G.A. § 48-2-7(c) states that “[a]ll employees of the department shall be compensated upon a fixed salary basis and no person shall be compensated for services to the department on a commission or contingent fee basis.”

**HB 93 – Direct Pay Permits failed to pass.** HB 93 would have legislatively amended the Department’s regulation that requires direct pay permit applicants to waive their entitlement to interest on sales & use tax refunds. After versions of the bill passed both the Georgia House and the Senate nearly unanimously, the two chambers failed to agree to a version that included unrelated provisions added through the committee process. The last version produced by a House/Senate conference committee is here. For more coverage of this issue, see here and here.

**Property Tax**

**HB 374 – Appeals Process.** HB 374 makes several updates to the property tax...
appeal process, which was previously overhauled during the 2015 legislative session. It lowers the threshold for the value of real property appeals eligible for hearing by a hearing officer, instead of the board of equalization or an arbitrator. Additionally, if a county board of assessors does not respond to a taxpayer’s appeal within 180 days, the taxpayer’s opinion of value is deemed accepted. The bill would also change several other deadlines in the appeals process.

**HB 888 Freeport Exemption.** HB 888 requires that the board of assessors respond to a taxpayer’s application for freeport exemption within 180 days, or the exemption is deemed accepted. The bill also clarifies that the assembly of component parts is manufacturing, and therefore qualifies for the freeport exemption.

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1 Unless otherwise indicated, the enacted legislation discussed awaits execution or veto by the Governor. The legislation will also become effective within 40 days if no action is taken by the Governor.


If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under “Related People/Contributors” or the Eversheds Sutherland attorney with whom you regularly work.
On March 21, 2018, the Georgia Legislature passed SB 328 (the Bill) to exclude IRC § 951A (GILTI) from Georgia taxable income. The Bill treats GILTI as Subpart F income for purposes of the deduction under OCGA § 48-7-21(b)(8).

Earlier in this legislative session, Georgia updated its conformity to the IRC to February 9, 2018, with the enactment of HB 918. HB 918 specifically excluded GILTI from the state’s dividends received deduction and thus GILTI would therefore be included in taxpayers’ Georgia taxable income. HB 918 also provided that the deduction under IRC § 250 would apply to the extent that the related income is included in Georgia taxable income. Subsequent to the passage of HB 918, the business community rallied to inform legislators of the potential negative impact of state GILTI inclusion on Georgia businesses, including: the misalignment of the state’s taxation of GILTI without the corresponding offset for foreign taxes paid, the departure from Georgia’s longstanding policy of not taxing the foreign income of foreign subsidiaries, and the potential constitutional challenges to state taxation of GILTI. SB 328 now awaits Georgia Gov. Nathan Deal’s signature.

If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under ‘Related People/Contributors’ or the Eversheds Sutherland attorney with whom you regularly work.
Public Law 115-97 (the Tax Cuts and Jobs Act (TCJA)) added a new foreign income inclusion rule for global intangible low-taxed income (GILTI) under section 951A. On September 13, 2018, the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations (Proposed Regulations), addressing section 951A and related provisions. The highly anticipated Proposed Regulations largely focus on the calculation mechanics of GILTI and leave foreign tax credit and certain other important questions open to be covered by later regulations. While no timeline is listed for additional guidance, Treasury officials have made statements indicating a release within approximately 60 days.

Notably, the Proposed Regulations do not include any rules relating to:

- Whether interest, rent and royalty payments from a controlled foreign corporation (CFC) to a US shareholder are in the GILTI basket for section 904(d) purposes.
- Foreign tax credits (FTCs), including the assignment of the section 78 gross-up for foreign taxes deemed paid under section 960(d) and the allocation of expenses to the GILTI separate limitation basket. However, the Preamble to the Proposed Regulations indicates that the section 78 gross-up related to GILTI inclusions will be assigned to the GILTI basket in future FTC guidance.
- Whether the deduction and its limitation under section 250 applies on a consolidated group basis.
- Subpart F and GILTI inclusion reduction where CFC stock is sold between US parties, and the pre-sale current year earnings are not subject to US tax due to the foreign source dividend deduction under section 245A.
- Whether the interest limitation under section 163(j) and the anti-hybrid provision under section 267A apply to calculate CFC tested income or loss (CFC tested income or CFC tested loss).

Importantly, the Proposed Regulations do provide that GILTI will be applied on a consolidated group basis in order to avoid potential distortions that otherwise could arise. The Proposed Regulations also provide certain rules that are not set out in the statute, including anti-avoidance rules, reporting requirements and rules for determining the GILTI inclusions for partners of domestic partnerships. In addition, the Proposed Regulations include changes to the rules for calculating a US shareholder’s “pro rata share” of subpart F income under hypothetical distribution rules, which are cross-referenced and expanded upon for purposes of determining a US shareholder’s pro rata share of the various
amounts relevant to the computation of GILTI.

The Proposed Regulations are generally proposed to apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of US shareholders in which or with which such taxable years of the foreign corporations end.

**Recap of General GILTI Rule**

Under section 951A, a US shareholder must include in gross income its GILTI with respect to CFCs whose taxable years begin after December 31, 2017. A US shareholder does not compute a separate GILTI inclusion with respect to each CFC, but rather, it computes a single GILTI inclusion amount by reference to all of its CFCs. GILTI is the US shareholder’s “net CFC tested income” less its “net deemed tangible income return” (Net DTIR). Net CFC tested income is the excess, if any, of the US shareholder’s aggregate pro rata share of each CFC tested income over its aggregate pro rata share of CFC tested loss. Net DTIR is 10% of a US shareholder’s aggregate pro rata share of a qualified business asset investment (QBAI) (i.e., depreciable tangible property used in a business that produces CFC tested income) of each CFC, reduced for its “specified interest expense.” CFC tested income, CFC tested loss, QBAI, and the two components of specified interest expense, tested interest expense and tested interest income, are collectively referred to as “CFC tested items.”

A deduction is provided under section 250 for 50% (37.5% for taxable years beginning after 2025) of the amount of the GILTI inclusion in calculating the US shareholder’s taxable income, resulting in an effective rate of tax of 10.5% (13.125% for taxable years beginning after 2025). In addition, 80% of the foreign income taxes attributable to the GILTI inclusion can be claimed as an FTC, subject to the general FTC limitation rules. Before taking into account the potential limitation resulting from expense allocation to the GILTI basket, a taxpayer’s GILTI inclusion will not be subject to US residual income tax if the income has been subject to an average foreign effective rate of tax of at least 13.125% (16.40625% for taxable years beginning after 2025). As noted above, the Proposed Regulations do not provide rules with respect to the section 250 deduction or FTCs.

**Discussion of Proposed Regulations**

The discussion below highlights some of the key takeaways from the Proposed Regulations.

**Consolidated Groups**

As noted above, the Proposed Regulations provide for the application of the GILTI regime on a consolidated basis, such that which CFCs are owned by which members of the group does not affect the group’s aggregate GILTI inclusion amount. Mechanically, the members’ pro rata shares of each CFC
tested item other than CFC tested income are aggregated and then allocated out to each member that is a US shareholder of a tested income CFC, in proportion to each member’s share of the total CFC tested income of the group. Stock basis adjustments are provided to take into account GILTI inclusions and the sharing of CFC tested losses.

Treasury and the IRS have requested comments regarding the proposed basis adjustments and whether additional rules related to earnings and profits (E&P) adjustments or any other of the consolidated return provisions are necessary.

**Determination of a US Shareholder’s Respective “Pro Rata Share” of Subpart F Income and CFC Tested Items**

The Proposed Regulations modify the existing regulations under section 951 governing the computation of a US shareholder’s pro rata share of subpart F income, which generally allocated subpart F income in proportion to the amount that would be distributed on each share if all of the CFC’s current E&P were distributed on the last day of its taxable year. Most notably, the Proposed Regulations provide the government with additional flexibility in challenging a taxpayer’s asserted allocation by (1) incorporating a “facts and circumstances” analysis for purposes of the hypothetical distribution test and (2) adopting a “principal purpose” anti-abuse rule that disregards any plan or arrangement undertaken with a principal purpose of avoiding federal income taxation, including by reducing a US shareholder’s pro rata share of subpart F income. In addition, the Proposed Regulations modify the amount of the hypothetical distribution to be the greater of (i) the CFC’s current E&P or (ii) the sum of the subpart F income and tested income of the CFC.

The same hypothetical distribution rules are applied for purposes of determining a US shareholder’s pro rata share of each CFC tested item, with certain modifications described below. In general, a US shareholder’s pro rata share of each CFC tested item is determined independently of its pro rata share of any other CFC tested item.

**CFC tested income.** A US shareholder’s pro rata share of a CFC’s tested income is determined in the same manner as its pro rata share of subpart F income under the hypothetical distribution test. However, a special rule applies where a CFC tested loss has been allocated to any class of stock in a prior CFC inclusion year. Generally, CFC tested income is first allocated to each class of stock to the extent of the prior CFC tested loss allocation.

**QBAI.** A US shareholder’s pro rata share of a CFC’s QBAI generally corresponds to its pro rata share of CFC tested income. A special rule limits the QBAI allocable to preferred stock to 10 times the CFC tested income allocated to the stock.

**CFC tested loss.** A CFC’s tested loss is generally allocated pro rata across its common stock. Special rules apply when the common stock has zero liquidation value.
Section 951A(c)(2) requires that the gross tested income of a CFC be taken into account. CFC income that applies in determining a CFC's subpart F income. CFC tested income (or loss) of a CFC is therefore determined under taxable income principles as if the CFC were a domestic corporation. Consequently, only items of deduction that would be allowable in determining the taxable income of a domestic corporation may apply in determining a CFC's subpart F income. CFC tested income (or loss) of a CFC is therefore determined under taxable income principles as if the CFC were a domestic corporation. Consequently, only items of deduction that would be allowable in determining the taxable income of a domestic corporation may be taken into account, but Prop. Treas. Reg. § 1.952-2 requires that gross income and deduction determinations be made under the existing rules of Treas. Reg. § 1.952-2 that apply in determining a CFC's subpart F income. CFC tested income (or loss) of a CFC is therefore determined under taxable income principles as if the CFC were a domestic corporation. Consequently, only items of deduction that would be allowable in determining the taxable income of a domestic corporation may be taken into account.

The Proposed Regulations impose additional reporting requirements with respect to CFCs (a new schedule to Form 5471) and US shareholders of CFCs (new Form 8992 U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)) to provide the information required for the GILTI calculation.

Calculation of CFC Tested Income and Loss

CFC tested income and CFC tested loss are calculated by subtracting from a CFC’s gross income certain items described below (yielding “gross tested income”) and properly allocable deductions (including taxes). Section 951A does not specify the scope of the deductions that are to be taken into account, but Prop. Treas. Reg. § 1.951A-2 requires that gross income and deduction determinations be made under the existing rules of Treas. Reg. § 1.952-2 that apply in determining a CFC’s subpart F income. CFC tested income (or loss) of a CFC is therefore determined under taxable income principles as if the CFC were a domestic corporation. Consequently, only items of deduction that would be allowable in determining the taxable income of a domestic corporation may be taken into account.

Section 951A(c)(2) requires that the gross tested income of a CFC be determined without regard to certain items, including (i) effectively connected income (ECI), (ii) gross income taken into account in determining subpart F income, (iii) gross income excluded from foreign base company income (FBCI) or insurance income of the CFC by reason of the “high-tax exception” under section 954(b)(4), (iv) dividends received from a related person, and (v) any foreign oil and gas extraction income (FOGEI). The Proposed Regulations clarify that the exclusion related to the high-tax exception applies only to income that is excluded from FBCI solely by reason of an election to apply the high-tax exception.

The Proposed Regulations provide that all CFC tested items, including CFC tested income and CFC tested loss, are translated at the average exchange rate for the CFC inclusion year of the tested income CFC, consistent with the rule that applies with respect to inclusions of subpart F income.

Anti-Abuse Rule
The Proposed Regulations include what the Preamble refers to as anti-abuse provisions that prevent certain reductions in GILTI related to basis step-ups attributable to certain related-party transfers. Specifically, the Proposed Regulations disallow any loss or deduction related to stepped-up basis in depreciable or amortizable property that results from a related-party transaction entered into in 2018 before the transferor CFC is subject to the GILTI regime (i.e., before the end of its last taxable year beginning before 2018). As discussed below, the Proposed Regulations provide a similar rule disregarding basis in tangible property created in certain taxable transfers for purposes of calculating a CFC’s QBAI.

**Gross Income Taken into Account in Determining Subpart F Income**

The Proposed Regulations take the approach that if gross income is included in a category of subpart F income under section 952(a), it is taken into account in determining subpart F income, and therefore is excluded from gross tested income. Any E&P limitation or related recapture under section 952(c) that alters the US shareholder’s subpart F inclusion therefore does not affect the amount excluded from gross tested income. As a result, subpart F-type income is excluded from gross tested income even if there is no subpart F inclusion for the year due to the E&P limitation. Correspondingly, gross income may give rise to both a subpart F inclusion and gross tested income in a later year when section 952(c)(2) applies to treat non-subpart F-type income as included under subpart F.

**Eversheds Sutherland Observation:** Under the statute, a CFC’s E&P is increased by the amount of its CFC tested loss for purposes of applying the section 952(c) E&P limitation. As a result, the E&P limitation will generally only apply going forward when a CFC has E&P deductions that are not taken into account for purposes of determining CFC tested income or CFC tested loss. One relevant scenario is when there is positive subpart F income in one category of subpart F income and a subpart F loss in another category of subpart F income or a FOGEI loss, because the subpart F loss or FOGEI loss cannot give rise to a CFC tested loss. A second scenario is when the CFC has a current year E&P deduction that is not taken into account for purposes of measuring either subpart F income or CFC tested income.

**Eversheds Sutherland Observation:** Because a subpart F loss does not reduce CFC tested income, a taxpayer may have a GILTI inclusion attributable to a particular CFC in excess of that CFC’s net income. Similarly, because earnings treated as subpart F income due to section 952(c) recapture are not excluded from gross tested income, a taxpayer may end up with a total income inclusion under subpart F and GILTI attributable to a particular CFC in excess of that CFC’s net income.

Comments are requested on the application of the rules under Treas. Reg. § 1.952-2 for purposes of determining subpart F income, CFC tested income and
CFC tested loss (specifically whether these rules should allow a CFC deduction, or require a CFC to take into account income that is expressly limited to domestic corporations). Additionally, the Proposed Regulations note that Treasury and the IRS welcome comments on other approaches to determine CFC tested income (or loss), including whether additional modifications should be made to Treas. Reg. § 1.952-2 for purposes of calculating GILTI. The Preamble notes that future guidance will be provided on the applicability of sections 163(j) and 267A for purposes of section 951A, on which taxpayers have requested guidance.

**Eversheds Sutherland Observation:** The Preamble indicates that questions have arisen on whether a CFC should be entitled to a dividends received deduction under section 245A, which by its terms only applies to dividends received by a domestic corporation. As the Preamble references by a citation, the Conference Committee Report to the TCJA indicates that it was the intention of Congress that section 245A would apply at the CFC level, on the basis that under the section 952 regulations, taxable income of a CFC is determined as if the CFC were a domestic corporation. Moreover, the rule of section 245A(e)(2) treating hybrid dividends received by a CFC as subpart F income would not by its terms apply if dividends to CFCs were not generally within the scope of section 245A. Accordingly, while confirmation would be welcome, there does not appear to be a significant question about the application of section 245A at the CFC level.

**Qualified Business Asset Investment (QBAI)**

With respect to the determination of QBAI, the Proposed Regulations fill in several definitional or computational gaps in the statute. For instance, the Proposed Regulations:

- Use section 168 to define tangible property (the basis of which may be included in QBAI); the Preamble states that section 168 was adopted as the standard because there is a substantial amount of guidance related to section 168.

- Provide that the requirement to determine the adjusted basis of any property using the alternative depreciation system (ADS) under section 168(g) applies regardless of the date on which the property was acquired.

- Confirm that tangible property of a tested loss CFC is not taken into account in calculating QBAI.

- Provide rules for annualizing the QBAI calculation for a CFC with a short tax year.

- Provide rules for taking into account QBAI with respect to tangible property owned by a partnership based on the partner’s distributive share of the relevant gross income, which is all tested gross income where the property
does not produce directly identifiable income.

Treasury and the IRS request comments on the proposed approach to specified tangible property held through a partnership, including the rules addressing specified tangible property that does not produce directly identifiable income.

**Anti-Abuse rules**

The Proposed Regulations also include two anti-abuse rules relevant to the calculation of CFC QBAI. Under both rules, certain basis amounts of tangible property are disregarded for purposes of calculating a tested income CFC’s QBAI. Under the first rule, the basis in property is disregarded if the property is acquired with a principal purpose of reducing a US shareholder’s GILTI inclusion and the property is held temporarily but over at least one quarter close. Property held by the tested income CFC for less than a 12-month period is treated per se as temporarily held and acquired with such a principal purpose. Under the second rule, which is similar to the basis disallowance rule for CFC tested income or loss calculations, a step-up in tangible property basis is disregarded for purposes of determining QBAI to the extent the step-up is attributable to an acquisition from a related CFC after 2017 during the transferor CFC’s last taxable year beginning before 2018, except to the extent a US shareholder was subject to tax on the gain (e.g., under subpart F). The purpose of this rule is to prevent taxpayers from achieving a step-up in basis for purposes of QBAI without taking into account the gain under section 965 or GILTI.

**Eversheds Sutherland Observation:** The presumption that tangible property held for less than 12 months was acquired with a principal purpose of reducing GILTI and the lack of any possibility of rebuttal, imposes a significant compliance burden and potential tax cost on taxpayers that is not clearly justified by policy concerns. It is not uncommon in the context of significant business acquisitions for the acquirer to dispose of unwanted acquired assets in the period following the acquisition. This rule introduces an inefficient incentive to postpone such distributions in certain situations, and requires an after-the-fact reevaluation of a taxpayer’s QBAI calculation depending on what assets may have been disposed of, even after the relevant tax year has ended.

**Specified Interest Expense**

As noted above, Net DTIR is computed by subtracting specified interest expense from 10% of a US shareholder’s pro rata share of QBAI. The Proposed Regulations adopt a netting approach to determine specified interest expense, providing that specified interest expense is generally the excess, if any, of the aggregate of the US shareholder’s pro rata share of interest expense taken into account in determining the CFC tested income or CFC tested loss of the relevant CFCs over its aggregate share of interest income similarly taken into account.

Interest expense is defined broadly to include any expense or loss treated as
interest expense under the Internal Revenue Code (the Code) and any other expense or loss incurred in which the use of funds is secured in consideration of the time value of money.

The Proposed Regulations exclude from this calculation certain interest expense and interest income of CFCs engaged in the active conduct of a banking, financing, or similar business or a qualifying insurance business.

**Domestic Partnerships and Their Partners**

The Proposed Regulations provide that a domestic partnership that is a US shareholder of a CFC will be treated as an entity for purposes of calculating GILTI attributable to any domestic partner that is not itself a US shareholder of the CFC, but as an aggregate for purposes of the GILTI calculations of a domestic partner that is a US shareholder of the CFC. Thus, partners of the US shareholder partnership that are not themselves a US shareholder take into account their distributive share of the partnership’s GILTI inclusion, while US shareholder partners are required to include such a CFC in their combined GILTI calculation, based on their indirect ownership of the CFC through the partnership. Similar rules apply in the case of tiered domestic partnerships.

Due to the extensive calculations required, the Proposed Regulations require partnerships to provide partners with both their distributive share of the partnership’s GILTI inclusion and their proportionate share of the partnership’s pro rata share of each CFC tested item.

Treasury and the IRS request comments on whether any other approach to the treatment of domestic partnerships and their partners for purposes of GILTI, including a pure entity approach or pure aggregate approach, would be more appropriate. Comments are also requested regarding appropriate adjustments related to computing a GILTI inclusion amount, in whole or in part, at the level of the partner of a domestic partnership (including the partner’s basis in the partnership, section 704(b) capital account, the partnership’s basis in CFC stock under section 961, and a CFC’s previously taxed E&P under section 959).

**Interaction with Other Provisions**

The Proposed Regulations contain several additional provisions addressing the interaction of GILTI with other Code provisions.

*Treatment of GILTI Inclusion Amount*

Under the statute, any GILTI amount included in the gross income of a US shareholder is treated in the same manner as an inclusion of subpart F income for purposes of certain specifically identified Code sections (e.g., section 959, addressing the distribution of previously taxed E&P). In response to a comment, the Proposed Regulations add section 1411 (related to the taxation of net
Eversheds Sutherland Observation: The Proposed Regulations do not add section 960(c) to the list, meaning that for the time being uncertainty remains on whether any excess FTC limitation in the GILTI basket can be relied upon in a later year to provide capacity to claim FTCs for foreign taxes imposed on the distribution of previously taxed E&P attributable to GILTI inclusions. It is anticipated that the forthcoming proposed regulations addressing FTC issues may provide guidance on the interaction of section 960(c) and GILTI.

Further, the Preamble makes four related noteworthy points: (i) because the GILTI inclusion amounts are treated as section 951(a)(1)(A) inclusions for purposes of section 959, an inclusion under section 951A is determined before an inclusion under section 951(a)(1)(B), and the Treasury and the IRS believe that a requested clarification is not needed; (ii) the Treasury and the IRS intend to issue a separate notice of proposed rulemaking to update the regulations under section 959 and section 961 to account for the TCJA’s modifications to the US international tax system, including the enactment of section 245A; (iii) separate guidance will also address the characterization of GILTI inclusions for purposes of determining the unrelated business taxable income of tax-exempt entities; and (iv) the Treasury and the IRS request comments on other areas in which the characterization of GILTI inclusion amounts is relevant, and whether, in those areas, the subpart F treatment or some other treatment would be appropriate.

Treatment of GILTI Inclusion Amount as Includable in a US Shareholder’s Gross Income

Section 267(a)(3)(B) generally permits deductions for items accrued and payable to a related CFC only when actually paid (i.e., cash method of accounting), except to the extent that the amounts attributable to these items are includable in the US shareholder’s gross income. Section 163(e)(3)(B)(i) provides a similar rule for original issue discount on debt instruments held by a related CFC. The Proposed Regulations provide that an item is treated as includable in the gross income of a US shareholder for purposes of these sections to the extent it is taken into account in determining the US shareholder’s GILTI inclusion amount (i.e., increases the pro rata share of CFC tested income, reduces the pro rata share of CFC tested loss or both).

Adjustments to CFC Basis

The Proposed Regulations also require a basis reduction in the stock of a CFC to reflect the use of CFC tested losses from that CFC in certain cases. The concern is that because a pro rata share of CFC tested loss of one CFC may offset the pro rata share of CFC tested income of another CFC in determining a US shareholder’s net CFC tested income, such loss could produce a benefit of reducing a US shareholder’s GILTI inclusion and later produce a duplicative benefit by reducing taxable gain upon the direct or indirect taxable disposition of...
Accordingly, the Proposed Regulations provide that in the case of a corporate US shareholder (excluding regulated investment companies and real estate investment trusts), for purposes of determining the gain, loss or income on the direct or indirect disposition of stock of a CFC, the basis of the stock is reduced by the net amount of CFC tested loss of the CFC that has been used to offset CFC tested income of other CFCs in calculating net CFC tested income of the US shareholder. This basis reduction is only made at the time of the disposition. If the basis reduction exceeds the adjusted basis in the stock immediately prior to the disposition, the excess amount is treated as gain from the sale of the stock.

Rules are provided for cases where a tested loss CFC is indirectly disposed of as a result of a disposition of an intervening foreign entity and for certain non-recognition transactions.

**Eversheds Sutherland Observation:** The basis adjustment rule is premised on the taxpayer having received a tax benefit from the use of the CFC tested loss, but in many instances use of a CFC tested loss to reduce a US shareholder’s GILTI inclusion will not reduce the US shareholder’s US tax liability. Many taxpayers will have significant excess FTCs in the GILTI basket, which cannot be carried forward or back and thus have no value. For such taxpayers, utilization of a CFC tested loss will not reduce their US tax cost; it will merely increase their unusable excess GILTI basket FTCs. Nevertheless, upon a future disposition of the tested loss CFC, the taxpayer will be required to pay tax on incremental gain due to the required basis adjustment.

The Treasury and the IRS request comments on the basis adjustment rule, including with respect to the need for (i) additional adjustments to stock basis or E&P, (ii) similar rules for non-corporate US shareholders not entitled to the dividends received deduction under section 245A, and (iii) a modification of the definition of “disposition.”

**Conclusion**

In light of the anti-abuse rules provided by the Proposed Regulations, taxpayers with fiscal year CFCs should review any anticipated or executed transactions which could impact the calculation of CFC tested income or CFC tested loss and CFC QBAI going forward. The anti-abuse rules included within the rules for calculating CFC tested income or CFC tested loss can have broad application since they also encompass property subject to amortization under section 197.

Taxpayers should take note that net income of a CFC can in certain circumstances be subject to inclusion twice under both subpart F and section 951A because CFC tested income is determined without regard to the subpart F E&P limitation under section 952(c). In addition, the Proposed Regulations will significantly increase certain taxpayers’ compliance burden to ensure
appropriate application of the rules related to US shareholder partnerships and
the tracking of used CFC tested losses over an ownership period in order to
make required basis adjustments in CFC stock.

Those issues aside, much of the guidance in the Proposed Regulations is
largely focused on the calculation of the GILTI inclusion itself. In particular,
guidance with respect to the application of GILTI to consolidated groups was
welcome. Nevertheless, the Proposed Regulations leave taxpayers anxious for
additional guidance considering the remaining open questions related to GILTI,
in particular with respect to FTCs.

If you have any questions about this legal alert, please feel free to contact any of
the attorneys listed under 'Related People/Contributors' or the Eversheds
Sutherland attorney with whom you regularly work.
On December 22, 2017, the President signed into law the bill formerly known as the Tax Cuts and Jobs Act (the Final Bill), which was passed by the House of Representatives and the Senate earlier in the week. The passage of the Final Bill came after the Senate parliamentarian ruled that the “Tax Cuts and Jobs Act” name violated Senate rules, forcing the Final Bill to be renamed the somewhat less catchy “To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” and Congress secured a “pay-go” waiver allowing the President to sign the Final Bill in 2017.

The House-Senate Conference Committee released the Final Bill on December 15, 2017. The House previously passed its version of the Tax Cuts and Jobs Act (the House Bill) on November 16, 2017, and the Senate previously passed its version of the Tax Cuts and Jobs Act (the Senate Bill) on December 2, 2017. See the prior Eversheds Sutherland alerts on the House Bill and the Senate Bill.

**Eversheds Sutherland Observation:** The Final Bill is the most substantial overhaul of the Internal Revenue Code since 1986. The Final Bill is far-reaching and will make significant changes to how the US taxes individuals, domestic businesses and multinational businesses.

This alert summarizes the principal provisions impacting domestic and multinational businesses. See the Eversheds Sutherland Tax Reform Law blog for more information about the Final Bill, including alerts on the accounting methods, compensation and benefits, energy, insurance and international provisions of the Final Bill.

**Taxation of Domestic Businesses:**

- **Rate Reduction:** The centerpiece of the business tax reform measures in the Final Bill is a reduction in the corporate tax rate from 35% to 21%, effective for taxable years beginning after December 31, 2017. A corresponding change is made to the current dividends received deduction (DRD) for dividends paid by domestic corporations to other domestic corporations, specifically reducing the 80% and 70% DRDs to 65% and 50%. This means that the effective rate of tax on dividends received by domestic corporations from other domestic corporations remains nearly the same as under current law.

- **Elimination of the Corporate Alternative Minimum Tax (AMT):** The Final Bill eliminates the corporate AMT, adopting the approach taken by the House Bill.

- **Limitation on the Use of New Net Operating Losses (NOLs):** An 80%
NOL limitation (determined without regard to the deduction) is enacted for losses arising in taxable years beginning after December 31, 2017. The Final Bill also eliminates the current rules that allow a two-year carryback of NOLs, but it expands existing carryforward rules to permit unlimited carryforwards for losses arising in taxable years beginning after December 31, 2017.

- **Eversheds Sutherland Observation:** The 80% NOL limitation ensures that taxpayers cannot fully offset their taxable income with carried forward losses, and thus effectively ensures a 4.2% minimum rate of tax for any profitable year.

- **Limitation on the Ability to Deduct Interest:** Existing interest expense limitations that apply to related party interest are expanded such that taxpayers may only deduct net business interest expense to 30% of adjusted taxable income. Adjusted taxable income generally is defined as income, not including any: (i) items not allocable to a trade or business; (ii) business interest or business interest income; (iii) NOLs; (iv) deduction for qualified business income; (v) for taxable years beginning before 2022, any deduction allowed for depreciation, amortization or depletion; and (vi) any other adjustments provided by the Internal Revenue Service (IRS). Disallowed business interest generally may be carried forward indefinitely.

  - For corporations that are members of consolidated groups, the Joint Explanatory Statement of the House-Senate Conference Committee provides that this limitation is intended to apply at the consolidated group level. Also, the limitation does not apply to certain regulated utilities or real property trades or businesses.

- **Reduced Rate for Certain Income from Pass-Through Entities:** Generally allows a taxpayer other than a corporation to deduct 20% of the taxpayer’s qualified business income, qualified real estate investment trust dividends, qualified publicly traded partnership income and qualified cooperative dividends for the taxable year, subject to limitations based on the taxpayer’s taxable income for the taxable year.

  - The portion of the deduction that is attributable to qualified business income requires a separate deduction amount to be computed for each qualified trade or business of the taxpayer. The separate deduction amount computed for each qualified trade or business is subject to a limitation based on the W-2 wages and the unadjusted basis of qualified property with respect to the qualified trade or business (subject to a phase-in, as discussed below).

  - A qualified trade or business generally includes any trade and business of the taxpayer other than (i) the trade or business of performing services as an employee, and (ii) certain specified service trades or
Limitation on Excess Business Loss:

- Specified service trades or businesses generally include businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, including the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.

- In the case of a partnership or S corporation, the deduction is computed and taken into account at the partner or shareholder level, respectively.

- Both the wage/basis limitation and the exception of specified service trades or businesses from the definition of qualified trade or business are subject to a phase-in, such that the limitation and exception, respectively, apply to any taxpayer whose taxable income for the taxable year is greater than $315,000 for married couples filing jointly or $157,500 for other taxpayers, in each case as adjusted for inflation.

- The deduction applies to taxable years beginning after December 31, 2017, but not to taxable years beginning after December 31, 2025.

Limitation on Like-Kind Exchanges:

- An “applicable partnership interest” generally is defined as a partnership interest in a partnership that entitles the taxpayer with a right to share in profits and losses of the partnership that is not subject to a substantial risk of loss, and for which the value of the partnership interest is determined in accordance with the passive activity loss rules.

- The three-year holding period requirement would not apply to (i) any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, including the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.

- In the case of a partnership or S corporation, the deduction is computed and taken into account at the partner or shareholder level, respectively.

- Both the wage/basis limitation and the exception of specified service trades or businesses from the definition of qualified trade or business are subject to a phase-in, such that the limitation and exception, respectively, apply to any taxpayer whose taxable income for the taxable year is greater than $315,000 for married couples filing jointly or $157,500 for other taxpayers, in each case as adjusted for inflation.

- The deduction applies to taxable years beginning after December 31, 2017, but not to taxable years beginning after December 31, 2025.

Limitation on Carried Interest:

- "Specified service trades or businesses generally include businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, including the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities."

- In the case of a partnership or S corporation, the deduction is computed and taken into account at the partner or shareholder level, respectively.

- Both the wage/basis limitation and the exception of specified service trades or businesses from the definition of qualified trade or business are subject to a phase-in, such that the limitation and exception, respectively, apply to any taxpayer whose taxable income for the taxable year is greater than $315,000 for married couples filing jointly or $157,500 for other taxpayers, in each case as adjusted for inflation.

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Limitation on Carried Interest:

- "An applicable partnership interest generally is defined as a partnership interest in a partnership that entitles the taxpayer with a right to share in profits and losses of the partnership that is not subject to a substantial risk of loss, and for which the value of the partnership interest is determined in accordance with the passive activity loss rules."

- In the case of a partnership or S corporation, the limitation is applied at the partner or shareholder level, respectively.

- A taxpayer applies the excess business loss limitation after applying the passive activity loss rules.

- The excess business loss limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026.
applicable partnership interest to be considered long-term capital gain.

- An “applicable partnership interest” generally is defined as a partnership interest received in connection with the performance of substantial services in a trade or business of raising or returning capital and investing in or developing securities, commodities, real estate (held for rental or investment), options or derivatives on those assets.

- The three-year holding period requirement would not apply to (i) any partnership interest held by a corporation, or (ii) any capital interest in the partnership that entitles the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of such partnership interest) or the value of such interest subject to tax as compensation upon the receipt or vesting of such interest.

- **Full Expensing for Five Years:** Expands bonus depreciation to allow full expensing of the cost of both new and used “qualified property” acquired and placed in service after September 27, 2017, and before January 1, 2023. The bonus depreciation rate is phased down for such property placed in service between 2023 and 2026 and is zero in 2027 and thereafter, and it is not available for certain regulated utilities or property used in a trade or business with certain floor plan financing.

- **Limitation on Like-Kind Exchanges:** Permits like-kind exchange treatment only with respect to real property (i.e., an exchange of intangibles or tangible personal property would no longer be eligible for such treatment).

- **Capitalization of Certain Research or Experimental Expenditures:** For taxable years beginning after December 31, 2021, requires specified research or experimental expenditures to be capitalized and amortized ratably over a five-year period (for activities conducted in the US) or over a 15-year period (for activities conducted outside the US).

- **Expanded $1 Million Limitation on Deductible Compensation:**
  - Expands the definition of applicable employer to any employer with registered securities or that is required to file reports under the Securities Exchange Act of 1934.
  - Expands the definition of covered employee to include the principal financial officer, in line with the Securities and Exchange Commission’s executive compensation disclosure rules.
  - Provides that once an individual qualifies as a covered employee in 2017 or later, that individual remains a covered employee with respect to that employer for all future years (regardless of changes in position,
amount of compensation or termination of employment).

- Repeals the exceptions to the limit on deductible compensation for commissions and performance-based compensation.

- **Expanded Limitation on Deduction for Meals**: Disallows employer deductions for entertainment expenses such as meals, travel and club dues.

  - However, the Final Bill retains the 50% employer deduction for meals related to the operation of the employer’s trade or business and, for 2018 through 2025, expands the 50% deduction limit to include expenses for food or beverage in the operation of on-site eating facilities.

**Taxation of Multinational Businesses:**

- **Participation Exemption System**

  - **100% Dividends Received Deduction (DRD) for Certain Foreign Source Dividends**: Implements a participation exemption system that generally provides for a 100% DRD for the foreign-source portion of dividends received from a foreign corporation by a United States shareholder (generally, a 10% owner) that is a corporation. The DRD is not available with respect to dividends received by a United States shareholder from a controlled foreign corporation (CFC) if the dividends are deductible by the CFC in computing its taxes (i.e., hybrid dividends). In addition, no foreign tax credits are allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD.

  - **Eversheds Sutherland Observation**: The significance of the DRD for many multinational corporations may be limited by the transition tax imposed on previously taxed income that could be distributed without additional US tax, and the tax on global intangible low-taxed income (GILTI), described below.

  - **Eversheds Sutherland Observation**: The Final Bill, unlike the House Bill and the Senate Bill, retains existing section 956. As a result, although dividends to United States shareholders of CFCs are not subject to US tax, investments in United States property will continue to result in inclusions subject to US tax at a 21% rate.

  - **Corollaries to the DRD**:

    - Reduces the basis in stock in foreign corporations to reflect distributions eligible for the DRD in calculating losses.
- **Permits the DRD with respect to deemed dividend distributions under section 1248 on sales of stock of CFCs.**

- **Requires recapture of net losses of a foreign branch that is transferred to a foreign corporation – an expansion of existing recapture rules with respect to losses of foreign branches.**

**Transition Tax:** The Final Bill imposes a one-time transition tax on a United States shareholder with respect to its investment in CFCs and certain other foreign corporations. The tax is generally imposed on the net aggregate amount of the United States shareholder’s pro rata shares of the previously untaxed foreign E&P of such CFCs and other foreign corporations. The tax is imposed at an effective rate of 15.5% to the extent of the amount of cash and cash equivalents held by such corporations, and 8% for any amount in excess thereof.

- The tax is imposed by increasing the subpart F income of CFCs and other foreign corporations for their last taxable year beginning before January 1, 2018. The effective rate is achieved through a DRD on the deemed subpart F inclusion.

- Previously untaxed foreign E&P subject to tax is the greater of such amount as of November 2, 2017, and December 31, 2017. The amount of cash and cash equivalents is the greater of (i) the amount as of the close of the last taxable year beginning before January 1, 2018, and (ii) the average amount as of the close of the last two taxable years ending prior to November 2, 2017.

- Foreign tax credits are only permitted with respect to the portion of the previously untaxed E&P subject to tax. No section 78 gross-up applies, and no deduction is permitted, for any foreign taxes for which a foreign tax credit is disallowed.

- Taxpayers may elect to pay the tax over eight years, paying 8% of the liability in each of the first five years, 15% in the sixth year, 20% in the seventh year and 25% in the eighth year.

**Rules Related to Passive and Mobile Income**

- **Current Taxation of Global Intangible Low-Taxed Income (GILTI):** Imposes tax on a US taxpayer’s GILTI, which is generally amounts in excess of a proxy for routine returns on tangible property.

  - The combined earnings of CFCs in which a taxpayer is a United States shareholder are included in a manner similar to subpart F income and subject to US tax as such. A 50% deduction for such income is provided, generally resulting in a US tax rate of 10.5% for
such income.

(1) For taxable years beginning after December 31, 2025, the deduction is reduced to 37.5%.

(2) A foreign tax credit is permitted for 80% of the foreign taxes paid with respect to such income. As a result, for a taxpayer able to utilize foreign tax credits, GILTI generally will not be subject to residual US tax if the average foreign tax rate imposed on such income is at least 13.125%.

(3) **Eversheds Sutherland Observation**: The Final Bill adopts the GILTI provisions from the Senate Bill rather than the parallel provision from the House Bill imposing tax on foreign high return amounts. While the impact of the provisions was generally similar, the mechanics of the GILTI provision, with a full income inclusion and 50% deduction at the US level, present additional complexities.

(4) **Eversheds Sutherland Observation**: GILTI and the associated foreign tax credits are determined on an aggregate rather than on a country-by-country basis. As a result, a United States shareholder may not be subject to tax on its GILTI even though it owns individual CFCs the earnings of which are subject to tax at a rate of less than 13.125%.

**Deduction for Foreign Derived Intangible Income**: Permits domestic corporations to deduct 37.5% of their foreign-derived intangible income (FDII), which calculates an amount similar to GILTI and multiplies that amount by the fraction of the income earned in the US that is attributable to property sold to a non-US person for foreign use or to services provided outside the US.

- **The FDII provision results in a reduced effective tax rate on covered income of 13.125%, subject to a taxable income limitation on the amount of the deduction allowed.**

- **For taxable years beginning after December 31, 2015, the deduction is reduced to 21.875%.**

- **Eversheds Sutherland Observation**: The Final Bill did not adopt a provision in the Senate Bill that would have specifically allowed certain intangible property to be distributed from CFCs to United States shareholders without gain recognition.

**Expanded Constructive Ownership**: Expands the constructive ownership attribution rules of section 958(b) to include “downward attribution” from a foreign person to a related person effective for the last
taxable year of foreign corporations beginning before January 1, 2018.

- **Eversheds Sutherland Observation**: Downward attribution may cause certain US persons to be treated as United States shareholders with respect to certain foreign corporations resulting in an inclusion under the transition rule even where their direct and indirect ownership is less than 10% and may cause certain corporations not previously treated as CFCs to be treated as CFCs going forward, resulting in additional reporting obligations and, in certain circumstances, potentially subpart F inclusions by certain United States shareholders.

- **Modified Definition of United States Shareholder**: Modifies the definition of United States shareholder to include any US person that owns 10% or more of the total value of shares of all classes of stock of a foreign corporation effective for taxable years of foreign corporations beginning after December 31, 2017.

- **Elimination of “30-Day Rule”**: Eliminates the so called “30-Day Rule” pursuant to which a United States shareholder includes any subpart F income in its gross income only if the foreign corporation was a CFC for an uninterrupted period of 30 days or more during its taxable year.

- **Eversheds Sutherland Observation**: The Final Bill, unlike the House Bill and the Senate Bill, did not make permanent the look-through rule for dividends, interest and royalties paid between related CFCs in section 954(c)(6), which is set to expire at the end of 2019.

**Prevention of Base Erosion**

- **Eversheds Sutherland Observation**: The Final Bill, unlike the House Bill and the Senate Bill, did not adopt the additional limitation on interest expense of certain US taxpayers that are members of worldwide groups.

- **Base erosion and anti-abuse tax (BEAT)**:

  - Generally imposes a 10% minimum tax (5% in 2018) on a taxpayer’s income determined without regard to tax deductions arising from base erosion payments (including the portion of a taxpayer’s NOL treated as related to base erosion payments) which generally cannot be reduced by credits other than the R&D credit and, until 2025, 80% of the PTC and ITC renewable energy credits and the low income housing credit.

    - For taxable years beginning after December 31, 2025, the rate increases to 12.5%. For affiliated groups that include a bank or securities dealer, the rates are increased by 1%.

    - Base erosion payments generally are amounts paid by a taxpayer to
a related foreign person that are deductible to the taxpayer or that create depreciable or amortizable asset basis.

• The BEAT applies to US corporations (other than regulated investment companies, real estate investment trusts or S corporations), which have average annual gross receipts of at least $500 million for the preceding three taxable years and which have a base erosion percentage (generally, deductible payments to foreign affiliates over total deductions) of 3% (2% for affiliated groups that include a bank or securities dealer) or higher for the taxable year.

• Eversheds Sutherland Observation: The Final Bill adopts the BEAT provision from the Senate Bill rather than the provision from the House Bill imposing an excise tax on certain amounts paid by US taxpayers to related foreign recipients.

− Anti-Hybrid Rules: Denies deductions for interest or royalties paid between related parties where the recipient is not required to include the payment in income, is permitted a deduction with respect to such amount, or the payor is a “hybrid entity.”

• Eversheds Sutherland Observation: The Final Bill contains a broad grant of authority for the IRS to issue guidance clarifying and potentially expanding the scope of this anti-hybrid provision.

− Rules for Transfers of Intangibles and Partnership Interests:

• Provides that outbound transfers of foreign goodwill or going concern value by a US transferor would be subject to current tax.

• Permits the IRS to specify the method used to determine the value of intangible property transferred, effectively reversing the result in Veritas Software Corp. & Subsidiaries, et al. v. Comm., 133 TC 297 (2009).

• Treats a foreign partner’s gain or loss from the sale or exchange of a partnership interest as effectively connected with a US trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange, legislatively overturning the recent decision in Grecian Magnesite, Industrial & Shipping Co., SA v. Commissioner, 149 T.C. 3 (2017).

(1) In general, if any portion of any gain on the disposition of a partnership interest would be considered effectively connected with a US trade or business under this provision, the transferee of the partnership interest is required to withhold 10% of the amount realized by the transferor, unless the transferor certifies that the
transferor is not a nonresident alien individual or foreign corporation.

(2) If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

(3) **Eversheds Sutherland Observation:** The Final Bill delays the effective date for the requirement to withhold on sales or exchanges of partnership interest to after December 31, 2017, while the substantive tax is imposed effective after November 27, 2017.

*If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Eversheds Sutherland attorney with whom you regularly work.*
M&A Structuring And Due Diligence After Tax Reform

By Taylor Kiessig, Frank Comparetto and Michele Spencer (September 7, 2018, 4:12 PM EDT)

The Tax Cuts and Jobs Act, signed into law on Dec. 22, 2017, is the most drastic change to the Internal Revenue Code since the enactment of the Tax Reform Act of 1986. While the TCJA did not change what constitutes a tax-free reorganization, the changes implemented by the TCJA are having a significant impact on domestic and cross-border mergers and acquisitions that is just beginning to be understood.

This article highlights certain of the TCJA’s changes relevant to M&A, considers how those changes will impact transaction structuring and diligence and, using the transition tax under Section 965 as an example, looks at how the changes may impact the allocation of tax risk in transactions.

Certain Changes Relevant to M&A

- The U.S. corporate tax rate was reduced from 35 percent to 21 percent.
- Section 168(k) permits full expensing of certain “qualified property” in the first taxable year in which such property is placed in service — bonus depreciation.
- Section 163(j) generally limits the deductibility of business interest to interest income plus 30 percent of a taxpayer’s “adjusted taxable income.”
- Under Section 172, post-2017 net operating losses, or NOLs, are subject to different limitations.
- Section 965 imposes a mandatory one-time transition tax on a U.S. shareholder’s interest in the previously untaxed earnings of certain non-U.S. corporations — transition tax.
- Section 951A imposes a new, current tax on global intangible low-taxed income, or GILTI, which operates, in effect, as a worldwide minimum tax on the income of controlled foreign corporations, or CFCs.
• Section 59A imposes a new base erosion and anti-abuse tax, or BEAT.

Structuring Considerations

Rate Reduction

The reduction in the corporate tax rate to 21 percent is the centerpiece of the TCJA and has a significant impact on M&A. This rate reduction decreases the cost of taxable dispositions to corporate sellers and lowers the value of tax attributes to corporate buyers because such attributes now offset correspondingly less tax. The reduced rate has also caused people to reevaluate traditional choice of entity decisions. Historically, the two levels of tax on corporate earnings — first at 35 percent at the corporate level and then at up to 23.8 percent when distributed to shareholders — significantly exceeded the tax burden on earnings of pass-through entities — generally subject to tax at individual rates that ranged up to 39.6 percent prior to the TCJA. With the corporate rate now permanently at 21 percent (unless changed) while individual rates are temporarily reduced — with the top marginal rate now 37 percent — this disparity may no longer be as certain, particularly in situations where cash does not need to be distributed currently. One certainty is that modeling will take on a new-found importance as people reevaluate historic assumptions.

Bonus Depreciation

The TCJA increases the bonus depreciation percentage from 50 percent to 100 percent for certain qualified property, which excludes goodwill and other intangible assets, acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. The bonus depreciation percentage phases down for property placed in service between 2023 and 2026, reaching 0 percent in 2027. This change should make asset purchases more attractive, with buyers seeking to allocate more of the purchase price to eligible qualified property. Sellers, on the other hand, driven by a desire to minimize depreciation recapture, among other considerations, are likely to have different preferences when it comes to allocating the purchase price. As such, expect additional importance to be placed on purchase price allocations in purchase agreements.

Interest Expense and BEAT

Unlike its predecessor, the 30 percent limitation under Section 163(j) applies to both related party and third-party debt. This limitation is causing companies to reexamine their capital structures and reconsider how they fund acquisitions. In addition, BEAT is effectively an alternative minimum tax for certain large corporations that is calculated by adding back certain deductible payments made to related parties. Deductible payments at issue include related party interest that is not subject to the limitation described above. While the reduced U.S. corporate tax rate makes the U.S. a more attractive jurisdiction in which to invest, Section 163(j) and BEAT will make it significantly more difficult for non-U.S. parents and acquirers of U.S. targets to reduce U.S. taxable income by using leverage in, and intercompany payments from, the U.S.

Treatment of NOLs

Post-2017 NOLs are only permitted to offset 80 percent of taxable income and cannot be carried back, which, coupled with the lower corporate tax rate, makes such NOLs less valuable moving forward. Pre-
2018 NOLs, which are not subject to this 80 percent limitation, may be more valuable. Following an ownership change, all NOLs, however, are subject to the Section 382 limitation — which generally operates to limit the ability to use pre-acquisition NOLs to offset post-acquisition income. The elimination of the NOL carryback has a significant impact on M&A and common structuring techniques. For example, where a target has significant transaction-related deductions in the short taxable period immediately prior to being acquired, any resulting NOL would be subject to the Section 382 limitation after the acquisition. Historically, seeking to monetize such an NOL prior to its limitation, parties often caused the target to carry back the short period NOL, seek a refund, and contractually allocate the resulting benefit. This is no longer a possibility.

**GILTI**

GILTI is a significant change from pre-TCJA rules under which non-U.S. earnings were generally not included in income of a U.S. shareholder until repatriated or where otherwise subject to certain other anti-deferral rules, such as the Subpart F regime, which remains in effect. GILTI is driving taxpayers to evaluate their existing structures and reexamine how they think about longstanding rules like the Subpart F regime, since Subpart F inclusions may be more attractive than GILTI in certain cases. In the M&A context, GILTI is generally not picked up at the U.S. shareholder level until the last day of the CFC’s taxable year on which the entity constituted a CFC. If a buyer acquires 100 percent of a target that is a calendar year CFC on Dec. 1, 2018, the buyer will become liable for a target’s entire 2018 GILTI inclusion. Therefore, a buyer should ensure that the purchase agreement allocates any GILTI inclusion between the buyer and seller or obtain a corresponding purchase price adjustment. A buyer should also consider making a Section 338(g) election to close the target’s taxable year, thereby avoiding pre-acquisition GILTI inclusion and obtaining a stepped-up basis in the target’s assets.

In the partnership context, the TCJA eliminated technical terminations that had resulted when 50 percent or more of the total interest in partnership capital and profits was sold or exchanged within a 12-month period. While this is generally viewed as a taxpayer-friendly change, technical terminations — e.g., upon the sale of a majority partnership interest — have historically been used to eliminate unfavorable elections and create a “clean” partnership.

The TCJA overturned Grecian Magnesite Mining[1] and, under Section 864(c), gain recognized on the sale or exchange of certain partnership interests will be treated as effectively connected income, or ECI to the extent the transferor would be allocated ECI upon a sale of assets by the partnership. Under Section 1446, a buyer now must deduct and withhold tax equal to 10 percent of the amount realized on the disposition of a partnership interest unless the seller furnishes an affidavit to the buyer stating, among other things, that the seller is not a foreign person. Such affidavits should become standard requests in purchase agreements, similar to Foreign Investment in Real Property Tax Act certificates.

Buyers generally are responsible for unsatisfied entity level liabilities. For this reason, buyers have always engaged in diligence of targets to identify tax exposure, which the parties can then contractually allocate, through adjustments to the purchase price, indemnities or otherwise. However, the TCJA has raised the stakes and the transition tax illustrates this point.

**The Transition Tax**

The transition tax is imposed on U.S. shareholders of certain non-U.S. corporations on the last day of such entities’ last taxable year that began before Jan. 1, 2018. Generally, such U.S. shareholders are
subject to current tax on their pro rata share of the amount of previously untaxed accumulated earnings of such corporations as of (i) Nov. 2, 2017, or (ii) Dec. 31, 2017, whichever is greater. The tax is imposed at an effective rate of 15.5 percent to the extent of cash and cash equivalents held by such corporations and 8 percent on the remainder of such earnings. Taxpayers may elect to pay the tax over eight years.

The transition tax raises several issues, both because of the potentially significant amount of liability and the ability of U.S. shareholders to elect to pay the liability over an extended eight-year period. Buyers of U.S. targets subject to the transition tax need to perform diligence on the targets’ transition tax calculations to assess the extent of exposure. Buyers will need to account for the fact that such targets may have elected to pay the tax over eight years and that, in the case of fiscal year targets, the liability could be a current-year item. Where a target has elected to pay the tax over eight years, certain triggering events may cause the remaining payments to be accelerated and immediately payable in full. Buyers will need to take this into account when integrating targets into their existing structures.

The transition tax can also raise issues for sellers. For example, where a U.S. shareholder that has elected to pay its transition tax liability over eight years sells a non-U.S. corporation with respect to which it had an inclusion, the tax also becomes immediately payable by the seller in full, unless the buyer enters into an agreement under which it agrees to be fully liable for the payment of the remaining tax.

In addition to its diligence on a target’s transition tax liability, a buyer will likely seek representations from the seller on whether the target has transaction tax liability and, if so, how much and whether it has elected to pay that liability over eight years. It seems likely that such representations will become standard. Buyers may seek to allocate the economic burden of any target transition tax liability through adjustments to the purchase price or through indemnification for breaches of representations or for pre-closing taxes — specifying that post-closing payments of transition tax liability are pre-closing taxes.

Conclusion

The TCJA made significant changes relevant to M&A. While the impacts of some of these changes are noted above, additional impacts will be discovered as further guidance is issued and as parties reexamine structures and planning ideas from before the enactment of the TCJA. How parties react to these impacts will shape transactions for the foreseeable future.

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Eversheds Sutherland LLP is a regular contributor to Tax Authority Law360.

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A non-tax lawyer’s guide to the Tax Cuts and Jobs Act

By Jeffrey Friedman, Nicholas Kump and Michael Resnick

On December 22, 2017, President Donald Trump signed into law the largest overhaul of the nation’s tax code since 1986, known as the Tax Cuts and Jobs Act (TCJA). While the reduction in the corporate income tax rate from 35% to 21% grabbed most of the headlines, there are several important considerations related to the TCJA that both tax attorneys and non-tax attorneys alike should be aware of as they plan for Q3 and Q4 2018 and beyond.

The TCJA is a detailed piece of legislation (it is 185 pages of fine print) with numerous technical terms and related forgettable acronyms. Even without a comprehensive understanding of the law though, all attorneys can serve their employers and clients more effectively by being aware of the important state and local tax (SALT) implications of tax reform, such as how states will conform to the TCJA, how the TCJA impacts development incentives for state and local governments, and the challenges and opportunities the TCJA presents for federal tax planning purposes.
State tax conformity

Because the TCJA reforms the federal tax code, the threshold question for SALT purposes is the extent to which a state conforms to the Internal Revenue Code. If a state does not conform as of December 22, 2017, then the Internal Revenue Code provisions in the TCJA will not apply at the state level, and there will be less of an impact on state taxation. On the other hand, if a state conforms to the Internal Revenue Code as amended by the TCJA, then taxpayers can expect a substantial impact on their state tax obligations. Many states anticipate that conforming their tax codes to the post-TCJA Internal Revenue Code will increase state tax revenue because the TCJA expands the tax base for states, but the corresponding rate reduction in the TCJA will not automatically be adopted by the states. Some states are beginning to respond to the TCJA with legislation that conforms to certain provisions, while excluding others.

For example, in 2018, Idaho enacted a law that generally conforms to the Internal Revenue Code as of December 21, 2017, but selected two provisions as to which it will conform as of December 31, 2017. One of the TCJA provisions adopted by Idaho adds certain earnings of foreign subsidiaries of US companies into the tax base. However, Idaho did not adopt the corresponding deduction from the TCJA. As a result, Idaho is like a child on Thanksgiving eating all the marshmallows off the top of the yams; the state takes the good part of the TCJA that corresponds to the Internal Revenue Code as of December 22, 2017, but selected two provisions as to which it will conform based on the political climate and the influence of certain industries in the state, among other factors. Still, other states keep it simple and take the good with the bad by simply conforming to the Internal Revenue Code as of the end of 2017.

Why state tax conformity matters to non-tax attorneys?

Generally, Internal Revenue Code conformity legislation is not controversial and is often just a formality. In 2018 though, this will not be the case, and states have the opportunity to shape how federal tax reform will impact their taxpayers’ obligations in each state. Non-tax lawyers should coordinate with their policy departments or lobbyists to identify these opportunities and potential threats regarding the impacts on their employers and their specific departments. For example, the TCJA eliminates or suspends the tax deduction for certain benefits previously offered to employees such as an employer’s reimbursement of an employee’s bicycle transportation expenses. Human Resource Department attorneys should be aware of these modifications and think about whether it might make sense to protect these benefits at the state level by coordinating a lobbying effort related to a state’s conformity legislation. More information and insights on employee benefits are available from Eversheds Sutherland attorneys online at: https://www.taxreformlaw.com/category/employee-benefits/.

Disincentivizing incentives from state and local governments

Under the TCJA, many incentives offered by state and local governments to corporate taxpayers may be considered part of the corporation’s taxable gross income for federal income tax purposes. In other words, the value of benefits offered to businesses by state and local governments for investing in a state or community may be included in the company’s tax base subject to federal income tax. As a result, cash grants, no-cost land or equipment, public infrastructure and improvements, or other similar transfers of money or property to a corporation from a governmental entity may be subject to tax under the TCJA if taxpayers do not take the proper precautionary measures. This modification is important because state and local governments often offer a wide variety of incentives to a business willing to invest in the state or locality. For example, Connecticut’s “First Five Plus Program” provides cash grants to taxpayers undertaking projects that create at least 200 new jobs and invest at least $25 million in the state. However, under the TCJA, contributions of money or property to a corporation by a governmental entity will generally be includible in gross income. Thus, to the extent a taxpayer receives a cash grant under this program, the grant would be included in the taxpayer’s tax base, and the taxpayer would have to pay tax on it.

This is a dramatic change from prior law, which encouraged state and local governments to offer these incentives by excluding “any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such)” from a corporation’s tax base.

Even without a comprehensive understanding of the law though, all attorneys can serve their employers and clients more effectively by being aware of the important state and local tax (SALT) implications of tax reform...

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4 E.g., S.P. 812, 128th Leg., 2nd Reg. Sess. (Maine 2018).
Why incentives matter to non-tax attorneys?
All attorneys should be concerned with the bottom line of their employers or clients, and the taxability of incentives offered by state and local governments significantly impacts a corporation’s bottom line. Non-tax attorneys, especially those involved in business planning decisions and construction projects in any capacity, should be aware that an incentive might not actually be that much of an incentive if the incentive increases the corporation’s tax obligations too much. There are opportunities to minimize the federal tax impact while maintaining the same net economic benefit of most incentives though, and attorneys should work with experts to properly structure these arrangements.

Federal issues
In addition to the impact of the TCJA on SALT planning, there are a number of issues that should be considered to address the broad-sweeping ramifications of federal tax reform. As previously mentioned, the corporate tax rate was reduced from 35% to 21% for years beginning after December 31, 2017. To fully take advantage of this permanent rate reduction, taxpayers should evaluate their treatment of all items of income and expense to ensure they are utilizing the most favorable available accounting methods to accelerate deductions into 2017 to reduce their taxable income in the last year taxed at the 35% rate, while concurrently deferring income into 2018 and beyond, which will be taxed at the reduced 21% rate.

A number of taxpayer-favorable accounting method changes that are available on an automatic basis include changes involving the treatment of tangible property (i.e., how a company treats materials and supplies, what constitutes a repair, when a partial disposition of an asset has occurred), depreciation, customer rebates and allowances, accrued compensation, and deducting prepaid liabilities. By adopting certain accounting methods, companies will be able to use those changes to produce a permanent tax benefit due to the corporate tax rate change. This permanent difference will have an immediate and direct impact on a company’s bottom line for not only 2017, but also for 2018 and beyond.

Beyond accounting for the reduced corporate tax rate, companies should also fully understand the implications of the full expensing provisions of the TCJA. The full expensing provisions of the TCJA expanded existing bonus depreciation to 100%, permitting a full deduction of the cost of “qualified property” acquired and placed in service after September 27, 2017, and before January 1, 2023. Companies will want to review all acquisitions between September 27, 2017, and December 31, 2017, to confirm that any acquired property is considered qualified property available for full expensing during this small window, when the benefit of full expensing is exacerbated when the 35% corporate tax rate for 2017 overlaps with the full expensing provision. Because the TCJA allows companies to take advantage of the bonus depreciation for any property acquired by year-end, there may be an ability to carry back the related net operating losses to prior tax years, file a carryback claim, and obtain an immediate cash refund.

The critical takeaway is that the TCJA includes provisions that reach many facets of a corporation’s business, and taxpayers should consider the potential opportunities and challenges presented by the TCJA in 2018 and beyond.

Additionally, the new provision also expanded the definition of qualified property to include used property. No longer will companies receive the benefit of bonus depreciation only upon the acquisition of new property. Due to these revisions, companies will now have to think twice about structuring deals as stock or asset acquisitions to take full advantage of the significantly broader full expensing provisions.

Conclusion
Many tax experts are just beginning to understand the implications of the TCJA, and this article only scratches the surface. The critical takeaway is that the TCJA includes provisions that reach many facets of a corporation’s business, and taxpayers should consider the potential opportunities and challenges presented by the TCJA in 2018 and beyond. More information on these opportunities and challenges is available at Eversheds Sutherland’s tax reform law website at: https://www.taxreformlaw.com/.
Honored as “Tax Lawyer of the Year” in 2011 by State Tax Notes, Jeffrey Friedman, partner in the Washington office and US Tax Practice Group Leader, provides sophisticated state and local tax planning, strategic advice, and advocacy to numerous Fortune 100 and industry-leading companies. His comprehensive practice includes state and local tax planning, compliance, legislation and policy, and litigation, and controversy matters involving income, franchise, sales and use, and property taxes. Jeff’s clients span a variety of industries, including e-commerce, energy, technology, and telecommunications. Jeff can be reached at jefffriedman@eversheds-sutherland.com.

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About the authors
State Tax After TCJA: Treatment Of International Income

By Jeffrey Friedman, Todd Lard, Eric Tresh, Todd Betor and Christopher Beaudro  
(May 8, 2018, 4:15 PM EDT)

The passage of the Tax Cuts and Jobs Act has sent some states scrambling to amend their own tax laws. In this special series, tax attorneys analyze the ongoing effects of the TCJA on various aspects of state tax law.

The Tax Cuts and Jobs Act, P.L. 115-97,[1] made sweeping changes to the Internal Revenue Code, and will have far-reaching implications for state tax systems that broadly conform to the IRC. This article focuses on the major state income tax implications of the TCJA’s international tax provisions, including:

- The transition tax imposed by revised IRC § 965;
- The foreign-source dividends received deduction, or DRD, allowed by new IRC § 245A;
- The tax on global intangible low-taxed income, or GILTI, in new IRC § 951A and related deduction in IRC § 250;
- The deduction allowed for foreign-derived intangible income, or FDII, in new IRC § 250; and
- The base erosion anti-abuse tax, or BEAT, imposed under new IRC § 59A.

A future article will address states’ specific responses to the above provisions, and the implications of those responses on corporate taxpayers.

The Transition Tax: IRC § 965

Federal Overview

IRC § 965 imposes a one-time transition tax on a United States shareholder[2] with respect to its investment in a “specified foreign corporation,” or SFC, which generally includes controlled foreign corporations[3] and certain other foreign corporations, based on their pro-rata share of an SFC’s post-1986 untaxed accumulated earnings and profits, or E&P.[4] The transition tax requires U.S. shareholders to include their share of SFC untaxed accumulated E&P in taxable income, by increasing the amount of subpart F...
income in proportion to the amount of SFC E&P.[5]

For purposes of determining the resulting transition tax liability, the E&P amounts are divided into two categories: cash (and cash equivalents) and non-cash amounts.[6] The cash amounts are taxed at an effective federal rate of 15.5 percent, and all remaining amounts are taxed at an effective rate of 8 percent.[7] The effective tax rate is achieved by providing deductions to U.S. shareholders (akin to a DRD) in the amount necessary to obtain the 15.5 percent rate on cash and cash equivalents, and 8 percent on the remaining untaxed accumulated E&P.[8]

Based on recent Internal Revenue Service guidance, however, the transition tax departs from the reporting mechanics of subpart F income. Instead, IR-2018-53 (March 13, 2018) advises taxpayers not to report the transition tax base or related deduction on page 1 of federal Form 1120. IR-2018-53 provides that the transition tax base is reportable on a separate “IRC 965 Transition Tax Statement,” with only the resultant tax liability reported on Schedule J, Part I, line 11 of Form 1120.[9]

The amounts from Schedule J, Part I, line 11 are reported on line 31 of Page 1 of Form 1120 (Total tax).[10] Despite the form mechanics, the transition tax base is still included in “taxable income” for federal income tax purposes. In calculating the transition tax for members of a federal consolidated group, Notice 2018-07 states that the IRS will promulgate regulations providing that “all of the members of a consolidated group that are United States shareholders of one or more specified foreign corporations will be treated as a single United States shareholder.”[11]

**The Transition Tax and the States**

If a state chooses to conform to the transition tax, it must determine how best to do so. States appear to have taken two main routes in conforming (at least in part) to the transition tax: (1) inclusion of the income after deduction (IRC § 965(a) inclusion and IRC § 965(c) deduction) and (2) full inclusion (IRC § 965(a) inclusion without IRC § 965(c) deduction).[12]

Each of these conformity approaches present different complications when considering how they interact with existing state treatment of subpart F income, foreign-source DRDs and filing methodologies (e.g., world-wide combined, water’s-edge combined or separate filing). For example, a state that conforms to the transition tax in calculating state taxable income may find that, absent legislative action, the transition tax is wholly excluded under the state’s existing subpart F income exclusion or other foreign-source DRD.[13]

States that choose to include the transition tax may also subject themselves to Foreign Commerce Clause scrutiny based on the U.S. Supreme Court’s decision in Kraft General Foods Inc. v. Iowa Department of Revenue.[14] In Kraft, the court held that Iowa’s inclusion of foreign-source dividends, but not domestic dividends, in a taxpayer’s apportionable tax base unconstitutionally discriminated against foreign commerce. Kraft may be implicated by a state’s conformity to the transition tax because it requires the inclusion of foreign subsidiaries’ income where there is no corresponding income inclusion for domestic subsidiaries.

IR-2018-53 may also present compliance issues for taxpayers. Most states direct taxpayers to calculate
their state taxable income by referencing amounts from line 28 or line 30 of Form 1120 to determine the “starting point” for calculating state taxable income. However, IR-2018-53 requires taxpayers to include the transition tax base and related deduction on the IRC 965 Transition Tax Statement, not line 28 or 30 of Form 1120.

Although not shown on line 28 or 30, the transition tax is included in the defined term “taxable income” for federal tax purposes. Thus, a state using line 28 or line 30 of Form 1120 as the starting point for calculating state taxable income should consider addressing whether it actually conforms to the transition tax. A state that references a specific line on Form 1120 via administrative guidance may simply be able to adjust its guidance in order to conform to the transition tax.[17]

In light of the IRS’s statement in Notice 2018-07 regarding the treatment of members of a federal consolidated group as a single U.S. shareholder in determining transition tax liability, there will likely be significant compliance burdens for taxpayers in separate return states that conform to IRC § 965 that require that the transition tax be computed on a separate entity basis. Potential complications may also arise in unitary combined and consolidated group reporting states, particularly where there is a disconnect in the composition of the federal consolidated group and the state’s reporting group. Taxpayers should also consider whether this income is unitary under the Due Process Clause and Mobil Oil Corp. v. Commissioner of Taxes.[18]

Lastly, if a state chooses to conform to the transition tax, it should be prepared to answer whether the receipts that generated the E&P that resulted in the transition tax must be represented in taxpayers’ apportionment formulae under the Fair Apportionment prong of Complete Auto Transit Inc. v. Brady.[19]

**Foreign-Source DRD: IRC § 245A**

**Federal Overview**

IRC § 245A allows corporate taxpayers a 100 percent deduction for the foreign-source portion of dividends received from a “specified 10-percent owned foreign corporation.”[20] The term “specified 10-percent owned foreign corporation” is defined as “any foreign corporation with respect to which any domestic corporation is a United States shareholder with respect to such corporation.”[21] This deduction will likely be included in special deductions taken on line 29b of Form 1120.

**States — Likely to Already Conform**

Several states allow for the deduction of foreign-source dividends because of Kraft. Absent explicit adoption of IRC § 245A, states may also conform to the foreign-source DRD based on their form mechanics depending on whether their starting point for calculating state taxable income is line 28 or line 30 of Form 1120.

Because it is likely that IRC § 245A will be a special deduction that is shown on line 29b of Form 1120, states that begin their income tax calculation with line 30 (federal taxable income after NOL and special deductions) would appear to conform to the foreign-source DRD. On the other hand, states that begin their income tax calculation with line 28 would appear not to conform.

Taxpayers in nonconforming line 28 states should, however, consider whether the state-specific DRD would allow for a similar deduction to IRC § 245A. States that choose not to conform to IRC § 245A or
otherwise exclude foreign-source dividends from taxable income will likely encounter constitutional challenges under Kraft.

**GILTI: IRC §§ 951A/250 & FDII: IRC § 250**

*Federal Overview*

GILTI and the FDII deduction, as enacted under the TCJA, are designed to operate in concert. We therefore discuss these provisions together.

Under IRC § 951A, a U.S. shareholder of any CFC is required to include its GILTI in taxable income for the tax year in a manner that is generally similar to that of subpart F income.[22] In general, GILTI is the excess of a U.S. shareholder’s net CFC tested income over such shareholder’s net deemed tangible income return for a given taxable year.[23] Like the effective rate deduction with the transition tax, taxpayers are generally able to take a deduction equal to 50 percent of their GILTI (and related IRC § 78 grossed-up foreign dividend) under new IRC § 250(a)(1)(B).

This deduction is designed to achieve an effective tax rate of 10.5 percent on GILTI, without regard to foreign taxes. The deduction is reduced to 37.5 percent for taxable years beginning after Dec. 31, 2025, resulting in an effective rate of 13.125 percent on GILTI. Taxpayers are permitted to claim a foreign tax credit for 80 percent of foreign taxes paid on CFCs’ income resulting in GILTI inclusion.

In addition to the GILTI deduction, IRC § 250 allows corporate taxpayers to take a deduction equal to 37.5 percent of FDII.[24] FDII is generally the amount which bears the same ratio to the corporation’s deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income.[25] The FDII deduction generally results in a reduced effective tax rate of 13.125 percent on FDII.

**GILTI States — To Include or Exclude? And What About FDII?**

Similar to the above provisions, states choosing to conform (at least in part) to GILTI and/or the FDII deduction have generally taken four routes in conforming: (1) conform to GILTI (both IRC § 951A and § 250) and the FDII deduction (IRC § 250); (2) conform to only GILTI (both IRC § 951A and § 250); (3) conform to only the GILTI inclusion (IRC § 951A); and (4) conform to only the FDII deduction.

The more controversial conformity method is where a state adopts the inclusion of GILTI, but excludes or requires an add-back of the corresponding deduction in IRC § 250(a)(1)(B) and/or the FDII deduction in IRC § 250(a)(1)(A). These partially conforming states may see an inequitable windfall as a result of an expanded tax base. Such a windfall could be viewed politically as a tax increase. Regardless of conformity method, the general exclusion of foreign tax credits at the state level may result in the tax impact from GILTI being of greater significance in conforming states than at the federal level.

States choosing to conform to GILTI (with or without the FDII deduction) may, however, run into similar challenges as those conforming to the transition tax. First, conforming states inclusion of GILTI may produce a Foreign Commerce Clause issue under Kraft. Second, states should consider whether GILTI must be represented in the apportionment factors under the Fair Apportionment prong of Complete Auto.[26]

Both of these considerations should also be reviewed by taxpayers, in addition to reviewing whether
GILTI (and FDII) is includable in the apportionable tax base in light of the unitary business principle.

Taxpayers should also consider how GILTI may be treated under existing state law. In order to make this determination, taxpayers should review how a state treats similar items of income including subpart F income, IRC § 78 grossed-up foreign dividends and other DRD provisions. Although GILTI is not subpart F income, it is included in “taxable income” like subpart F income.

Thus, if a state otherwise excludes subpart F income, it may likewise exclude GILTI. Accordingly, a line 28 state that otherwise does not provide for the GILTI FDII deductions in IRC § 250 may wholly exclude GILTI under its existing provisions. Existing state provisions may also otherwise exclude FDII. If a state with such a provision also conforms to FDII, it is not entirely clear whether the FDII deduction may still be taken.

The BEAT: IRC § 59A

Under new IRC § 59A, applicable taxpayers must pay an amount that is generally equal to the BEAT.[27] This figure is derived by comparing 10 percent (5 percent for tax years beginning in calendar year 2018) of the taxpayer’s modified taxable income (determined by disregarding certain deductions with respect to base erosion payments made to foreign related persons) to the taxpayer’s regular tax liability (reduced for certain credit amounts).[28] In effect, the BEAT is a minimum tax.

Absent a state explicitly adopting IRC § 59A, the BEAT does not appear to have current applicability to state income tax law.

Jeffrey A. Friedman, Todd A. Lard and Eric S. Tresh are partners and Todd G. Betor and Christopher Beaudro are associates at Eversheds Sutherland LLP.

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[2] A U.S. person that owns, directly, indirectly or constructively, 10 percent or more of the vote of the stock of a foreign corporation. IRC §951(b).

[3] Any foreign corporation where more than 50 percent of its stock (either by vote or value) is owned directly or indirectly by a U.S. shareholder. IRC §957(a).

[4] IRC §§965(a), (d)(2). The measurement date of the untaxed accumulated E&P is either Nov. 22, 2017, or Dec. 31, 2017, whichever date on which the E&P is greater.


[7] IRC §§965(c)(1), (c)(2). The resulting liability for the transition tax may be paid over a period of eight
years, paying 8 percent of the tax in each of the first five years, 15 percent in the sixth, 20 percent in the seventh and 25 percent in the eighth. IRC §965(h).

[8] IRC §965(c).

[9] Taxpayers taking advantage of the election in IRC § 965(h) to pay the transition tax over an eight-year period should report the tax on Schedule J, Part II, line 19d.

[10] The transition tax amounts from Schedule J, Part II, line 19d are reported on line 32 on Page 1 of Form 1120 (Total payments and refundable credits).


[12] See, e.g., Idaho Code §63-3022(d) (requiring the add-back of amounts deducted under IRC §965(c)).


[15] Line 28 of the Form 1120 shows a taxpayer’s federal taxable income before NOL and special deductions.

[16] Line 29 of the Form 1120 shows a taxpayer’s federal taxable income after NOL and special deductions.


[18] 445 US 425 (1980). In Mobil, the US Supreme Court held that to be engaged in a unitary business, the relevant entities must share centralized management, economies of scale and functional integration.


[20] IRC §245A.


[22] IRC §951A.

[23] IRC §951A(b)(1).


[27] IRC § 59A.

[28] Id.
Appendix
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**Appendix**

- Emory University
- John Marshall
- Mercer University
- University of Georgia
- Liaison Staff Liaison
- 2018
  - Cassady Vaughn Brewer
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