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The State of State Taxes: Impact of Federal Tax Reform, and Modernizing State Sales Tax Systems after *Wayfair*

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Speakers:

Douglas L. Lindholm
President & Executive Director
Council On State Taxation (COST)

Steve Barela
Director, Indirect Tax & Policy
Arizona Public Service Company

Agenda

- Impact of Federal Tax Reform on State Taxes
  - State Action to Date
  - Special Arizona Issues
- *Wayfair* and Its Aftermath:
  - Do non-SSUTA States Really Have Collection Authority?
  - Special Issues with Arizona Sales Taxes
  - Modernizing State Sales Tax Systems

Transformational Changes in the Tax Cuts and Jobs Act

- **Revenue Neutral vs. Deficit Financed**
  - The Tax Reform Act of 1986 provided for about $100 billion of (net) PIT cuts financed by about $100 billion of (net) CIT increases over 6 years.
  - The Tax Cuts and Jobs Act (P.L. 115-97) (TCJA) provides for $6 trillion over 10 years of tax cuts and only $4.5 trillion over 10 years of tax increases.
- **Transformational Changes**
  - **40 percent corporate tax rate cut** to sync up with OECD norms.
  - Lower effective PIT rate (20% deduction) for pass-through entities.
  - **The war on debt:** broad new limitations on the interest deductions.
  - **The crusade for investment:** 100 percent expensing of investments.
  - $10k limitation on state and local tax deductions for individuals.
- **International Tax Reform**
  - **Moves the U.S. from a worldwide to a quasi-territorial tax system** consistent with U.S. trading partners.
  - New foreign source tax provisions intended to raise revenues (to offset tax cuts) and tilt the playing field to favor domestic commerce over foreign commerce (e.g. GILTI; BEAT, FDII).

Quantifying the Impacts of TCJA on State Corporate Taxes

Impact of the TCJA on Corporations:

- A federal tax cut of about 10%.
- A state tax increase of about 12%.
  - COST/ EY study "The Impact of Federal Tax Reform on State Corporate Income Taxes" (based on 2018 update and pre-federal tax reform (FTR) linkage to IRC).

This outcome is **<u>inadvertent and arbitrary</u>**: If states simply conform to the TCJA, either automatically or by updating the conformity date, and do nothing more they will link to federal corporate base-broadening measures, but not to federal tax rate reduction.

Impact of Federal Tax Reform on Arizona

- For income taxes, Arizona conforms to the IRC effective January 1, 2017. (Tax Cuts & Jobs Act (TCJA) adopted 12/22/2017.)
- Impact on Arizona if conformity date is January 1, 2018:
  - **One-Time Repatriation Tax (IRC Sec. 965).** Conforms, but automatically decouples through 100% DRD.
  - **Global Intangible Low Taxed Income (GILTI).** Conforms automatically for 2018. (Potential 4.5% base *increase.*) Should decouple to avoid unintended tax increases through taxation of foreign source income, or at a minimum provide factor representation.
  - **Foreign-Derived Intangible Income (FDII).** Conforms automatically. (Potential 2.2% base *reduction.*)
  - **Federal Interest Limitation.** Conformity to TCJA. (Potential 7.6% base *increase.)*
  - **Immediate Expensing of Capital Purchases.** Conformity to TCJA but will continue to decouple as under current AZ law. Designed to offset the interest limitation, above.

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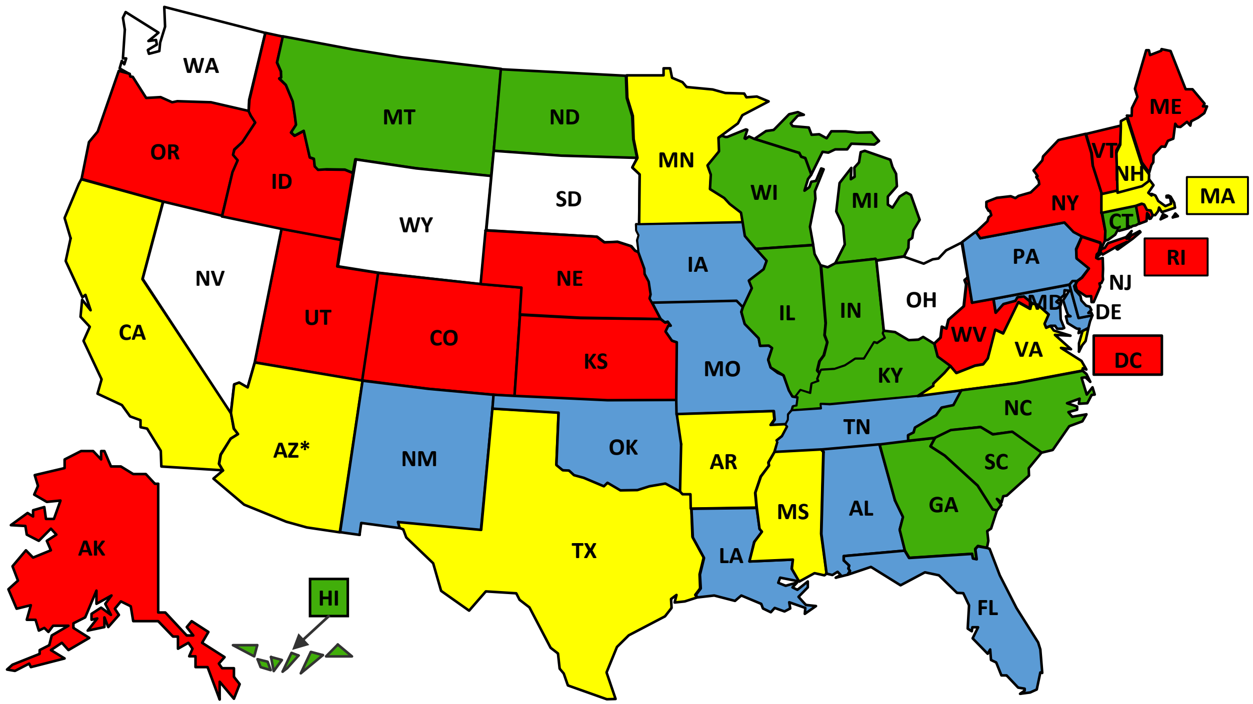
Current Status of State Conformity to GILTI

- Decoupled from GILTI by legislation or administrative action (in some states, subject to DRD limitations)
- Potentially coupled to GILTI, but inclusion is constitutionally prohibited in separate reporting states*
- Coupled or potentially coupled to GILTI**
- Have not addressed I.R.C. conformity and/or GILTI coupling specifically



* See Part III.D for discussion of the taxation of GILTI in separate company states.

** Generally, GILTI is not specifically referenced in state conformity statutes so there remains the possibility that some of these states will decouple from some or all of GILTI by administrative guidance (*e.g.*, Kentucky, Connecticut) or future clarifying legislation.

Source: Council On State Taxation

COST Article:
State Taxation of GILTI

COST Council On State Taxation

"State Taxation of GILTI: Policy and Constitutional Ramifications" by Joe Donovan, Karl Frieden, Ferdinand Hogroian & Chelsea Wood, State Tax Notes, Oct. 22, 2018

- **Key Findings**:
  - The state taxation of GILTI is a sharp departure from the historic limited state taxation of foreign-source income; and potentially constitutes the largest such expansion in the history of state taxation
  - The state taxation of GILTI is fundamentally different from the federal taxation of GILTI from both a policy and practical outcomes perspective
- **Based on their analysis, the authors recommend:**
  - That states decouple from the GILTI provision — as 12 states have already chosen to do
  - That all separate reporting states that conform or potentially conform to GILTI recognize they are constitutionally barred from taxing GILTI under the *Kraft* precedent
  - That all combined reporting states that do not decouple from GILTI provide apportionment factor representation for the foreign factors producing GILTI

WAYFAIR AND ITS AFTERMATH:

DO NON-SSUTA STATES REALLY HAVE COLLECTION AUTHORITY?

The *Wayfair* Decision: June 21, 2018

- In a 5-4 Decision, Justice Kennedy (joined by Thomas, Gorsuch, Ginsburg, Alito) held that:
    - *Quill* and *National Bellas Hess* are overruled
    - The physical presence rule is unsound, is an incorrect interpretation of the Commerce Clause, and restricts the states' authority to "collect taxes and perform critical public functions"
- Justice Kennedy: "Here, the nexus is clearly sufficient based **on both the economic and virtual contacts** respondents have with the State."
- However, Kennedy also noted that only the "substantial nexus" test in *Complete Auto* is modified. The other aspects of the constitutionality of state tax statutes were not addressed.

Wayfair Dicta: Threat, Warning, or Observation?

- The Question Remains: "Whether some other principle in the Court's Commerce Clause doctrine might invalidate [South Dakota's] Act."
- Features in South Dakota Designed to Prevent Discrimination or Undue Burdens on Interstate Commerce:
  - Safe Harbor
  - No Retroactivity
  - Adoption of Streamlined Sales & Use Tax Agreement:
    - Single State Level Administration
    - Uniform Definitions of Products and Services
    - Simplified Tax Rate Structures
    - Other Uniform Rules

Will More States Join SSUTA?

Streamlined Sales Tax States by Population

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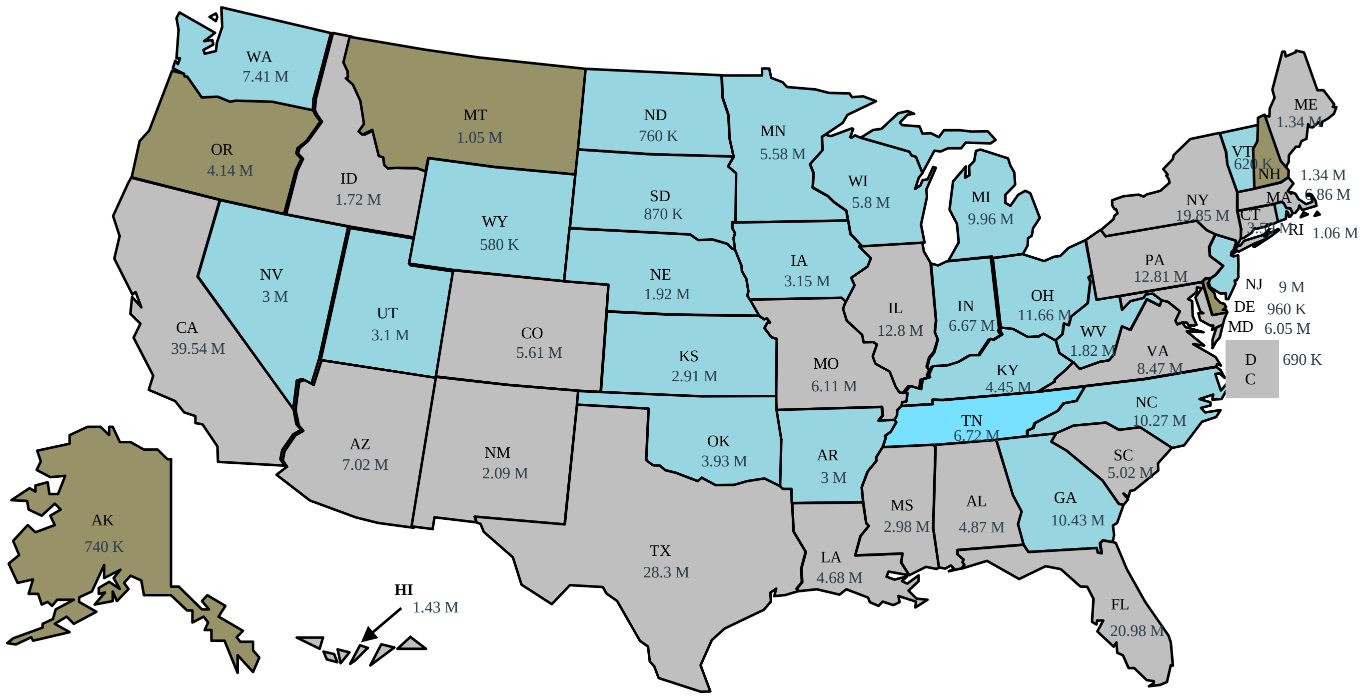
Full Member 33.7% of population

Associate Member 2% of population

Non-Sales Tax Member 2.5% of population

Non-Member 62.3% of population



Source: U.S. Census Bureau

COMPLIANCE CONCERNS UNDER ARIZONA'S SALES TAX SYSTEM

Sales Tax Compliance Issues in Arizona

- No Threshold legislation – No safe harbor guidance for small business remote sellers
- Arizona has one State Tax Code but 91 separate Municipal Tax Codes
- Nexus by jurisdiction for city tax collection may differ from state tax collection
- The AZ Model City Tax Code (MCTC) allows different options for taxing and exempting certain transactions
- The exemptions/deductions definitions under the MCTC do not match the exemptions/deductions definitions found in State statutes
- The MCTC allows different rates depending on the business classification
- The MCTC allows caps and thresholds or tiered rates, *i.e.,* different rates depending on the cost of the item
- Imposition of sales tax on services is complex and confusing
- Arizona received a D+ among all states by the COST Scorecard on Sales Tax Simplification and Uniformity

MODERNIZING (AND IMPROVING) STATE SALES TAX SYSTEMS

Why Modernizing State Sales Tax Systems Is Critical to State Tax Policy

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- **General sales taxes account for over 32 percent of all state taxes** – and along with personal income taxes – are the largest sources of state tax revenues.
- **The U.S. state and local sales tax system is one of the most complex and inefficient consumption tax systems in the world.**
  - **Exemption of Business Inputs**: Sales taxes were designed to tax end-user consumption (not a general gross receipts tax) – however, on average, 42% of the states' sales tax revenue is derived from business inputs. Virtually all other countries mitigate pyramiding of their consumption tax by providing more expansive credits for business inputs
  - **Uniformity and Simplification**: There is a much higher level of consumption tax uniformity in Europe (harmonization through the EU) than in the United States where the largest states with about two-thirds of the U.S. population have not adopted SSUTA.
  - **Central Administration**: While 45 states have sales taxes (plus DC), when taking into account local sales tax jurisdictions, there are over 10,000 separate taxing jurisdictions. Accordingly, the U.S. has one of the most decentralized tax consumption systems in the world.

State Sales Tax Systems: Scorecard Categories

- **The Best & Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity and the Exemption of Business Inputs**
  - First Edition released April 2018
- **Scorecard Categories**
  - Exemption for Business-to-Business Transactions
  - Fair Sales Tax Administration
  - Centralized Sales Tax Administration
  - Simplification & Transparency
  - Reasonable Tax Payment Administration
  - Fair Audit/Refund Procedures
  - Other Issues Impacting Fair Tax Administration
- **What the Scorecard Does <u>Not</u> Grade**
  - Tax Rate Differences
  - Tax Base Breadth (other than Taxing Business Inputs)

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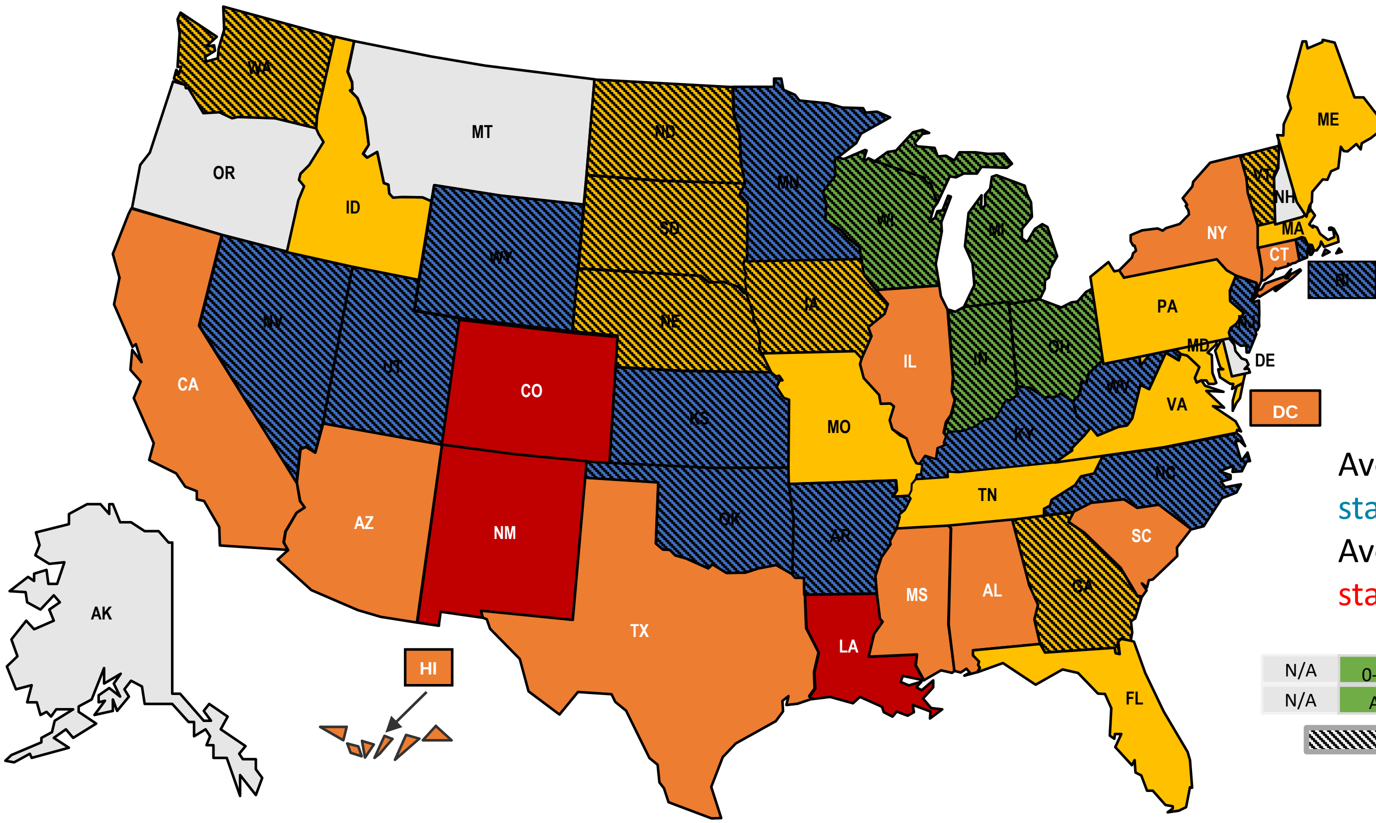
Overall Scorecard Grades: SSUTA vs. Non-SSUTA States



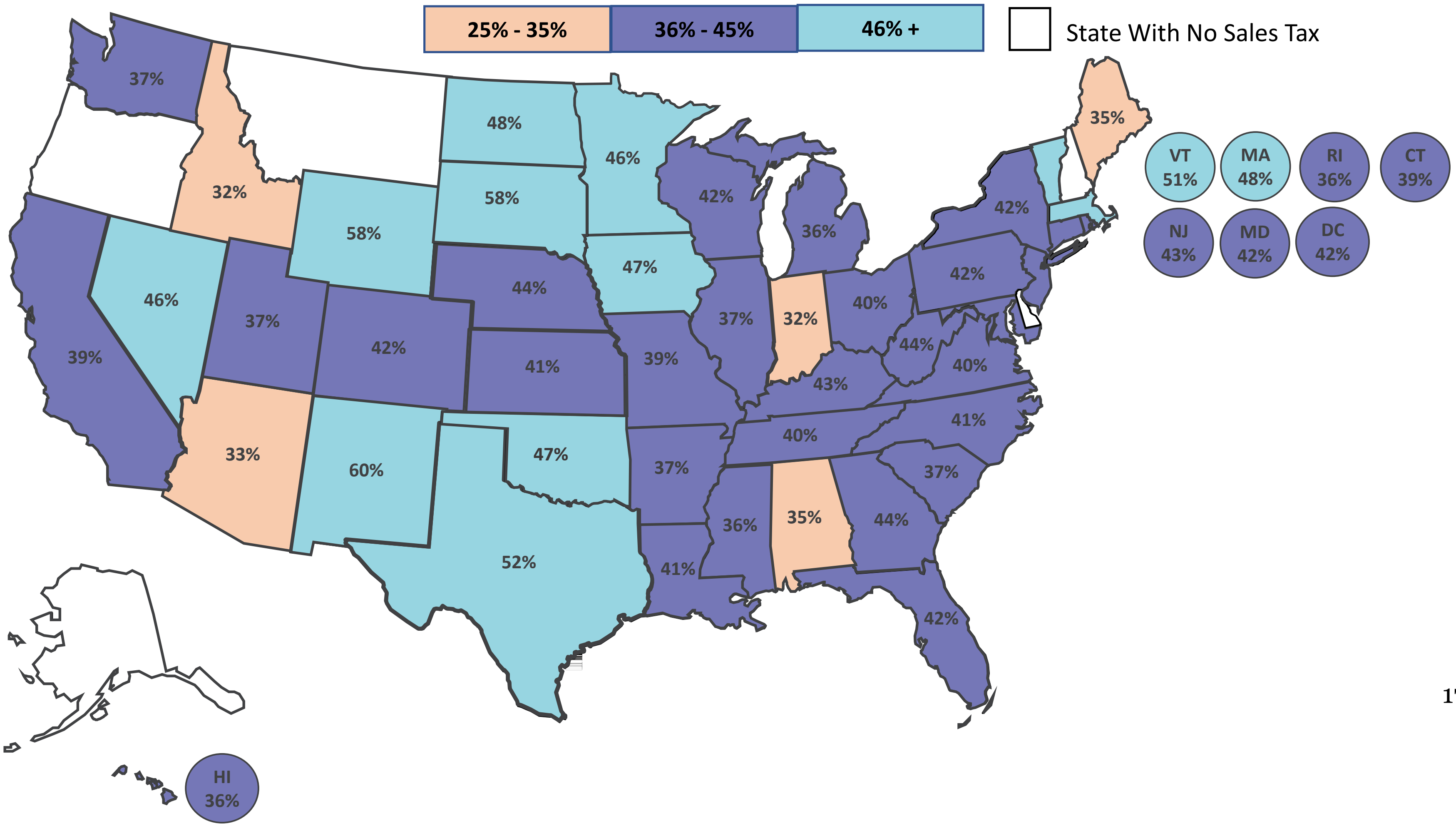
Average score of **SSUTA** states: B (12 pts.)

Average score of **non-SSUTA** states: D+ (19 pts.)

N/A	0-9	10-13	14-17	18-22	22+
N/A	A	B	C	D	F

SSUTA Full Member

Sales Taxes from Business Inputs as a Share of Total Sales Tax Collected



QUESTIONS?

dlindholm@cost.org

steve.barela@aps.com