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January 29, 2019

VIA EMAIL

Kansas Legislature
Senate Select Committee on Federal Tax Code Implementation
The Honorable Susan Wagle, Chair
The Honorable Dan Kerschen, Vice Chair
The Honorable Tom Holland, Ranking Minority Member

Re: COST's Support for S.B. 22, Internal Revenue Code Corporate Decoupling

Dear Senator Wagle, Senator Kerschen, Senator Holland, and Members of the Select Committee,

On behalf of the Council On State Taxation (COST), I am writing in support of legislation (S.B. 22) that would decouple Kansas from some of the most significant and harmful corporate tax base expansion provisions of the 2017 federal Tax Cuts and Jobs Act (TCJA).

While the TCJA enacted a significant corporate tax rate decrease at the federal level, this benefit does not have the same impact with state corporate income tax calculations. Taken together, COST estimates that the Kansas corporate tax base would expand by 11% as a result of TCJA conformity. Because Kansas is a "rolling" conformity state that adheres to Internal Revenue Code (IRC) updates automatically, the State's corporate tax base expansion is entirely inadvertent. Further, as outlined below, several of the specific decoupling measures in S.B. 22 would reverse otherwise unfair, harmful, and potentially unconstitutional results of conformity to the TCJA. These include the "transition tax" under IRC Sec. 965, global intangible low-taxed income (GILTI) under IRC Sec. 951A, and the interest expense limitation under IRC Sec. 163(j).

About COST

COST is a nonprofit trade association consisting of approximately 550 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST has a significant number of members that own property, have employees, and make substantial sales in Kansas.

COST's Research on the State Corporate Tax Impact of Federal Tax Reform

In March 2018, COST, through its affiliated State Tax Research Institute (STRI), issued a study entitled The Impact of Federal Tax Reform on State Corporate Income Taxes.[1] The study, conducted by Ernst & Young LLP, determined that state tax conformity with federal tax reform would result in an average state corporate income tax base increase of 12 percent over the 10-year period between 2018 through 2027. For purposes of this estimate, the study assumed that states would update their conformity dates to link with the Internal Revenue Code as of January 1, 2018 (including the changes under the TCJA) but remain decoupled from specific federal provisions as they have in the past. The study concludes that Kansas would experience an approximately 11 percent increase in its corporate income tax base if it conformed to the TCJA. This increase is averaged over the next 10 years, and the estimated corporate tax base increase for each year varies depending on the timing of the various federal changes. The two most significant items producing the estimated Kansas corporate tax base increase are discussed in more detail below.

Global Intangible Low-Taxed Income (GILTI)

Over the last 30 years, states have generally limited their corporate income tax base to the water's edge (*i.e*., to only income earned in the U.S.). With federal tax reform, the federal government is moving from the taxation of all foreign source income primarily on a "deferred" basis to taxing a more limited range of foreign source income – including global intangible low-taxed income (GILTI) – primarily on a "current" basis. However, federal taxation of GILTI is very different than state taxation of GILTI from both a policy and a practical outcome perspective.

First, Congress is raising $324 billion over 10 years from the international tax reform provisions (including GILTI) to help pay for $654 billion over 10 years in other business tax reform cuts. The states, by contrast, do not conform to the federal corporate tax rate cuts. Therefore, the states have no reason to expand their tax base to make up for the lost revenue. Conforming to the GILTI provisions would represent a selective and arbitrary conformity that harms a segment of Kansas businesses competing internationally, without advancing any compelling tax policy goal for the State.

Second, at the federal level, the focus of the GILTI provision is to include in the federal income tax base "low-taxed" foreign source income – basically income that is taxed in foreign countries at less than 13.125 percent. To achieve this practical outcome, the federal government imposes a tax rate of 10.5 percent (one-half of the federal statutory rate) on GILTI income and allows a credit for 80 percent of foreign taxes paid on such income. However, state corporate income tax laws in Kansas, and in other states, do not allow for foreign tax credits. Therefore, all of the GILTI income, from low and high-tax countries, would be subject to state corporate income tax. This would constitute a vast and unprecedented expansion of the state corporate income tax base to include previously untaxed foreign earnings.

[1] *The Impact of Federal Tax Reform on State Corporate Income Taxes*, by Ernst & Young LLP for the State Tax Research Institute, March 2018, available at: http://cost.org/globalassets/cost/state-taxresources-pdf-pages/cost-studies-articles-reports/the-impact-of-federal-tax-reform-on-state-corporateincome-taxes.pdf.

As a result, to date, at least 12 states have decoupled from the GILTI provisions and more are likely to follow. Among the states fully (or 95%) decoupling (by new or existing legislation or administrative action) from GILTI are Connecticut, Georgia, Hawaii, Illinois, Indiana, Kentucky, Massachusetts, Michigan, North Carolina, South Carolina, Pennsylvania, and Wisconsin. Further, other states such as Montana and North Dakota include 30% or less of GILTI in their corporate tax base consistent with their preexisting treatment of foreign dividends.

Interest Expense Limitation under IRC Sec. 163(j)

The federal provision with the largest impact on the Kansas corporate income tax is the 30% limitation on net interest expense deductions under the revised I.R.C. Sec. 163(j). This limitation on business interest expenses would expand the Kansas corporate income tax base by an average of approximately 7.5% over the next ten-year period. Once again, this corporate base broadener at the federal level funded, in part, the substantial reduction in federal corporate tax rates to make the U.S. more competitive internationally. These rate reductions, of course, do not flow through to the states, and therefore Kansas conformity would result in a substantial corporate income tax increase.

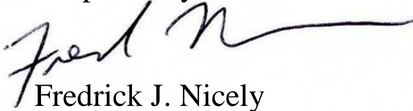
The state-specific outcomes are arbitrary and inconsistent with the goals of federal tax reform. For example, the I.R.C. Sec. 163(j) provisions limit interest expense across the board, for both intercompany and third-party borrowing, and thus impact all borrowing by Kansas taxpayers for both business operations and investment/expansion. This result harms Kansas' competitiveness, especially in light of decisions by states in 2018 to decouple from these provisions (see, *e.g.*, Connecticut, Georgia, Indiana, South Carolina, Tennessee, and Wisconsin).

Applying the interest expense limitation in Kansas would also significantly increase the complexity of corporate tax compliance, as much remains to be determined, both at the federal level and by the Kansas Department of Revenue, on how to implement this provision. It is uncertain how the interest expense limitation will be computed and reflected in federal consolidated return filings, and commensurately how to determine if, and in what amount, the limitation applies at the state filing level. No state has answered these questions to date (and answers to these questions will depend on analysis and further development of federal guidance).

Conclusion

For the aforementioned reasons, COST urges the Committee to support the corporate tax decoupling provisions contained in S.B. 22. I look forward to answering any questions from the Committee on this testimony or COST's research in this area.

Respectfully,



Fredrick J. Nicely

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director