



Conformity to the Federal Tax Base

Prepared by:
Inez M. Mello, M.B.A.
MFA - Moody Famiglietti & Andronico



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Prepared by: Inez M. Mello, M.B.A.

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Income Tax Issues:

Inez M. Mello

Conformity to the Federal Tax Base:

The starting point for computing a corporation's state taxable income is usually either the federal taxable income before the dividends-received and net operating loss deductions (Line 28 of federal Form 1120) or federal taxable income (Line 30 of federal Form 1120). Thus, the computation of state taxable income is directly affected by the Internal Revenue Code (Code). The adoption of the Code may be to either the current Code or the Code as of a specific reference date. A state that adopts the current Code automatically incorporates any changes in the federal statutes into the states statutes. In contrast, a state that adopts the Code as of a specific reference date must periodically update its statutes to ensure conformity to the current Code. For most states that adopt the federal provisions as of a specific reference date, annual legislation to ensure the update of state statutes becomes almost automatic. If adoption of federal statutory provisions is delayed, corporate taxpayers must consider the differences that may arise in the computation of state corporate taxable income.

The use of the federal tax base as the starting point for computing state taxable income is referred to as "piggybacking". Conformity with federal provisions simplifies tax compliance for multistate corporations, but complete conformity with the federal tax laws would effectively cede control over state tax policy to the federal government. States also must be wary of the effects of federal tax law changes on state tax revenues. Therefore, although federal taxable income generally is used as the starting point in computing state taxable income, numerous state modifications are required to reflect differences in federal and state policy objectives.

Generally, the states find it difficult to evaluate the effect of federal tax legislation on state revenues. Some states respond quickly with legislation affecting state tax laws; other defer their response until the impact of the federal tax changes is more fully known.

For an example, a major component of the federal Job Creation and Worker Assistance Act of 2002 was bonus depreciation equal to 30 percent of the adjusted basis of qualified property placed in service between September 11, 2001, and September 10, 2004. The Congressional Research Service estimated that, if adopted, bonus depreciation could cost the states as much as \$14 billion in lost tax revenues over the three-year period. As a consequence, many states, already under serious budgetary pressures due to the sagging economy, decided to "decouple" from the Code with respect to the bonus depreciation.

States also may have difficulties with conformity to federal tax laws for other reasons. For example, in *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance* [505 U.S. 71 (1992)], the U.S. Supreme Court held that administrative convenience does not justify discrimination. Having found that Iowa's disparate treatment of domestic and foreign dividends discriminated against foreign commerce, the Supreme Court turned to the state's administrative convenience argument. Iowa argued that adopting the federal dividend treatment was administratively advantageous. The Court, however, found that the state could have retained its tie-in to federal taxable income with only minor adjustments. The Court held that Iowa's treatment of foreign dividends violated the Commerce Clause.

The modifications to federal taxable income vary significantly among the states. Common additional modifications include the following:

- Interest income received on state and municipal debt obligations
- State income taxes
- Federal net operating loss carryover deductions
- Federal dividends-received deductions
- Royalties and interest expense paid to related parties
- Expenses related to state tax credits
- Federal domestic production activities deduction under Code Sec 199
- Expenses related to income that is exempt for state tax purposes
- Federal bonus depreciation under Code Sec. 168 (k)
- Federal code Sec. 179 asset expensing

Common subtraction modifications include the following:

- Interest income received on federal debt obligations
- State net operating loss carryover deductions
- State dividends-received deductions
- Expenses related to federal tax credits
- Federal Subpart F income with respect to foreign subsidiaries
- Federal Code Sec. 78 gross-up

Advantages and Disadvantages of Conformity:

Advantages

Perhaps the greatest advantage to adopting a tax base that generally conforms to the federal tax base is the resulting simplicity. State conformity to the federal tax base spares multistate taxpayers the burden of having to deal with a multitude of disparate tax base rules.

Disadvantages

- Loss of autonomy and control. One major disadvantage of conformity to the federal tax base (at least from the states' perspective) is the loss of autonomy and control over fiscal projections.
- Delay and uncertainty unless a moving tax base is adopted. A disadvantage to a static federal tax base is the inevitable delay between the date federal law is enacted and the date on which a state will adopt or fail to adopt the federal changes. During this period, both taxpayers and state tax administrators are often uncertain regarding the state law interpretation. In addition compliance is compromised.

