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August 28, 2018

Ms. Kelley Askew Gillikin
Acting Director
Tax Policy and Governmental Affairs Division
Alabama Department of Revenue

Via E-mail

Re: Department of Revenue's Analysis of Federal Tax Law Revisions

Dear Ms. Gillikin:

On behalf of the Council On State Taxation (COST), we are writing to provide assistance to the Department of Revenue in its continuing efforts to analyze and communicate the impact of the Tax Cuts and Jobs Act ("federal tax reform") on Alabama taxpayers. Thank you for your outreach prior to the publication of the Department's "Analysis of Federal Tax Law Revisions on the State of Alabama" (July 30, 2018). We are submitting this letter to formalize and add to the informal comments we previously made to the Department's earlier draft report. Because COST's research specifically focuses on the state corporate income tax impact of federal tax reform, COST's comments are limited to this area.

COST respectfully submits for the Department's consideration the study performed by Ernst & Young LLP for COST's research affiliate, the State Tax Research Institute ("COST study").[1] The COST study reflects an average 12% corporate tax base expansion in the states over the first 10 years of implementation as a result of federal tax reform, and specifically for Alabama, an average 11% corporate tax base increase due to Alabama's rolling conformity to the Internal Revenue Code.

We understand and appreciate that the role of policymaking – and therefore mitigating any unintended corporate tax increase and resulting adverse consequences to the State – properly lies with the Alabama Legislature. However, COST believes the Department's analysis would be improved by adding the following items: a discussion of barriers to Alabama's conformity to certain provisions included within federal corporate tax reform (such as U.S. constitutional limitations); a discussion of

[1] See *The Impact of Federal Tax Reform on State Corporate Income Taxes*, prepared for the State Tax Research Institute by Andrew Phillips and Steve Wlodychak, Ernst & Young LLP, March 2018, available at: http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/cost-federal-tax-reform-3-1-2018-cost-v2.pdf.

how conforming provisions would be implemented by the Department (and potential complexities in doing so); and an identification of issues where additional guidance and regulations are most needed. For example, the report notes that the Department published guidance on April 27 regarding the Alabama reporting of I.R.C. Sec. 965 income. COST believes that while such guidance is helpful to taxpayers, it should be formalized through the Department's rulemaking process.

Further, although we understand from our earlier conversation that policy considerations would not be included in the Department's final analysis of federal tax reform, we are including some of the significant policy issues that the Department should consider as it communicates options to the Alabama Legislature and the Governor on corporate tax conformity or potential de-coupling.

Interest Expense Limitation under I.R.C. Sec. 163(j). The Department's analysis concludes that Alabama conforms to this new limitation on interest expense under federal tax reform. This accords with the assumption in the COST study. The analysis then provides that this limitation "will apply before Alabama's 'add back statute' (Sec. 40-18-35) adjustment is applied", and that for purposes of the add back statute, "the net interest deduction limitation will be allocated on a pro-rata basis to the interest income recipients." The analysis also provides an example.

COST believes that guidance on this issue, as well as other material conformity issues, is best provided by regulation, allowing for taxpayer notice, input, and a public hearing. Further, the Department's example makes no reference to the calculation of the federal limitation, whether there is a separate state calculation of the limitation for Alabama corporate taxpayers, and whether and how the limitation is assigned to each separate taxpayer. Moreover, the guidance does not provide a statutory basis or analysis for why the I.R.C. Sec. 163(j) limitation should be applied before the add back statute, or why the adverse impact of the add back statute should be made worse by applying the I.R.C. Sec. 163(j) limitation to the same interest payments, potentially frustrating the Alabama Legislature's intent in providing add back exceptions allowing full deductibility of certain interest expenses.

The Department's proposed ordering rule can cause double taxation by double disallowance of interest deductions and punishes legitimate and common forms of intercompany borrowing. Reversing the order of application of the I.R.C. Sec. 163(j) limitation and the add back statute disallowance rules would at least mitigate that risk.

COST also believes the Alabama Legislature would benefit from understanding the policy concerns with conforming to I.R.C. Sec. 163(j). Alabama's add back statute is targeted at abusive intercompany interest charges and provides exceptions meant to allow full deductibility of legitimate intercompany interest expense. However, 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 Alabama taxpayers for both business operations and investment/expansion.

This result punishes common business practices and harms Alabama's competitiveness, especially in light of Georgia's recent decision to decouple from this provision (H.B. 918,

enacted on March 2), as well as Tennessee's decision to decouple from this provision effective in 2020 (S.B. 2119, enacted on May 21). Mississippi already does not conform to this provision due to its separate allowance of interest expense deductions, and Florida's Department of Revenue is studying this issue as part of a statutory mandate to examine and report on the impact of federal tax reform. Thus, Alabama could be alone among its neighbors in implementing this provision, which does not advance an Alabama policy objective and is out of sync with the objective at the federal level to not impact domestic financing (federal consolidated group loans are eliminated from this calculation).

Global Intangible Low-Taxed Income (GILTI) under I.R.C. Sec. 951A. The Department's analysis concludes that Alabama conforms to this provision of federal tax reform and includes GILTI in the state corporate tax base. This is certainly one interpretation of Alabama's conformity with the new I.R.C. Sec. 951A (and accords with the "fallback" assumption in the COST study). However, there is another interpretation that several states have recently adopted through state department of revenue guidance (see, *e.g.*, Connecticut, Kentucky, and North Dakota) that treats GILTI in the same way as foreign dividends, fully or mostly exempting the GILTI income because of the state foreign dividends received deduction. This treatment would not only be consistent with Alabama's historic approach to foreign income taxation, it would avoid the complexities and challenges noted below.

Fundamentally, the inclusion of GILTI in Alabama taxable income appears to be a clear violation of the U.S. Constitution's Foreign Commerce Clause under *Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Finance*, 505 U.S. 71 (1992). The new federal taxation of foreign source income and related provisions are intended to shift the U.S. tax laws toward favoring domestic commerce over foreign commerce. While this may be a permissible goal for the federal government, states are limited by constitutional provisions such as the Commerce Clause and Foreign Commerce Clause that make it impermissible to favor domestic commerce over foreign commerce. The Alabama Legislature and the Governor should be apprised that while conformity to GILTI provisions may represent a modest short-term revenue increase, this revenue will be subject to extensive litigation and likely will need to be refunded to taxpayers at a later date. In the meantime, taxpayer planning and complexity of administration will distort business decisions and impose costs on the Department and on multinational employers doing business in Alabama.

Alabama conformity with GILTI not only violates settled constitutional law, but is also harmful from a state tax policy perspective. 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 the GILTI income and allows a credit for 80 percent of foreign taxes paid on such income. However, state corporate income tax laws in Alabama and in other states do not allow for foreign tax credits, and 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 Alabama state corporate income tax base to include previously untaxed foreign earnings.

As a result, to date, twelve states have decoupled from the GILTI provisions and more are likely to follow. Among the states already decoupling (by new legislation or administrative action)

from GILTI are Georgia, Kentucky, North Carolina, Indiana, Connecticut, Michigan, Wisconsin, Hawaii and North Dakota. Further, South Carolina, Illinois, and Montana do not include GILTI in their corporate income tax base due to existing decoupling from the Internal Revenue Code.

The expansion of the Alabama corporate tax base to include GILTI income would put Alabama at a competitive disadvantage, and particularly would burden Alabama-headquartered companies with international operations (and would likewise impact future business decisions to locate or expand in Alabama).

If the Department concludes it cannot issue regulatory guidance applying foreign dividend treatment to GILTI, it should at least caution state legislators on the constitutional infirmities (and policy drawbacks) associated with taxing GILTI income. It should also provide taxpayers with necessary information for applying this new federal provision, including the utilization of I.R.C. Sec. 250 deductions (which the final version of your report properly concludes will apply in Alabama). Finally, the Department's guidance should address how the GILTI inclusion would be reflected in the apportionment factors of separate Alabama corporate taxpayers by the inclusion of foreign property, payroll, and receipts in the denominators of the apportionment factors.

Conclusion. Thank you for the opportunity to provide comments on the Department's analysis of federal tax reform's impact on Alabama corporate taxpayers. Please contact us with any questions or to discuss these issues in more detail.

Sincerely,

Karl A. Frieden

Ferdinand S. Hogroian

cc: Douglas L. Lindholm, COST President & Executive Director
Joe W. Garrett, Jr., Alabama Deputy Commissioner of Revenue