FINAL REPORT FROM THE JOINT LEGISLATIVE TASK FORCE ON THE TAX CUTS AND JOBS ACT (TCJA)

February 18, 2020

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Final Report of

the Joint Legislative Task Force on the Tax Cuts and Jobs Act

Purpose of the Task Force

The Tax Cuts and Jobs Act of 2017, Public Law 115-97 (TCJA) enacted changes to the federal tax system beginning in tax year 2018 that can greatly impact the amount of federal income taxes paid by individuals and corporations. Because Alabama corporate income tax begins with federal taxable income with various adjustments, including a deduction for federal income taxes paid or accrued, the net impact of the federal tax changes on Alabama corporate income taxes cannot be determined without considering these adjustments.

The Legislature passed a joint resolution (Appendix 1) in May of 2019 that created the Joint Legislative Task Force on the Tax Cuts and Jobs Act to "study the fiscal impact of the act on corporate income tax in this state."

The members of the Task Force are as follows:

House	**Senate**
Representative J. Daniel Garrett (Co-Chair)	Senator Daniel J. Roberts (Co-Chair)
Representative Joseph F. Lovvorn	Senator Vivian D. Figures
Representative Roderick H. Scott	Senator Arthur W. Orr

Activities and Approach of the Task Force

The Tax Force commenced its work with an initial meeting in Montgomery on August 13, 2019. Since commencement, members of the Task Force have diligently studied the effects of the TCJA on Alabama taxpayers and its likely impact on the Education Trust Fund (ETF) budget. This diligent study included meetings with Alabama business leaders, corporate tax directors of many of Alabama's leading public and private companies, Alabama lawyers and accountants who practice specifically in the area of state and local tax (SALT), leading Alabama academics teaching the SALT curriculum, State of Alabama officials in the Revenue, Commerce and Legislative Services Departments, ETF legislative budget chairs and multiple members of Alabama government. Volunteers from the Alabama Society of CPAs assisted with calculations of the effects of the TCJA on Alabama taxpayers illustrating various common scenarios. The Task Force also studied the responses of other states to the TCJA and evaluated how Alabama's tax policies compare to other states in the southeastern U.S. The Task Force also reviewed multiple reports issued by independent "think tanks" and study groups such as the Tax Foundation, the American Legislative Exchange Council, and the Council on State Taxation. The Task Force also considered Alabama's competitive position versus surrounding states in terms of business formation and growth. Finally, the Task Force considered the spirit of Alabama's tax policies and of the TCJA initiatives and considered the general fairness to Alabama taxpayers as a result.

Basic Precepts of State Business Income Taxation

There are five principal drivers of state business income tax calculations:

1) Conformity (or not) to the Federal Income Tax Code (IRC)
2) Statutory Tax Rate (this also includes consideration of the Federal Income Tax (FIT) deduction in Alabama)
3) Apportionment of Business Income Among Multiple States
4) Unitary Combined versus Separate Company Reporting
5) Tax Credits and Incentives

Additionally, a business can choose a form of legal entity that is treated as a non-taxable, pass-through entity (PTE), such as a partnership, limited liability company (LLC), S corporation, or sole proprietorship, in which case the business' income is taxed at the owner level. Because many of Alabama's prominent businesses operate as PTEs, and most small businesses in this state (and across the country) operate as PTEs, and since the TCJA materially impacted PTEs, the Task Force also studied the effects of the TCJA on individual taxpayers.

Federal Income Tax Conformity

For corporations, Alabama corporate income tax law conforms to most federal income tax provisions on a rolling basis, which means Alabama conformed to relevant provisions of the TCJA automatically and without any legislative or administrative action. See Ala. Code section 40-18-1.1 and section 40-18-33. For individuals, unlike many other states, the Alabama individual income tax provisions are not directly tied to the calculation of federal taxable income or federal AGI (Adjusted Gross Income), and instead, certain individual provisions conform to the federal provisions on a rolling basis.

See Ala. Code section 40-18-1.1, section 40-18-13, section 40-18-14, and the *Analysis of Federal Tax Law Revisions on the State of Alabama Executive Summary issued by the Alabama Department of Revenue, dated July 30, 2018* [https://revenue.alabama.gov/wp-content/uploads/2018/07/180730_TCJAeffectsAlabama.pdf].

The Task Force found that there are multiple changes in the TCJA that have the net effect of substantially increasing the corporate taxable income of Alabama businesses. These changes are commonly referred to as "Expanders". These changes include items such as the net interest limitations, like-kind exchange limitations, deferred amortization of research and development costs, repeal of the domestic activities production deduction, and a complete change to approaching global taxation. Though the effect on any one corporation would depend on individual facts and circumstances, a study by Ernst & Young LLP for the State Tax Research Institute (EY Study) estimated that the Expanders alone would increase Alabama corporate income taxes by as much as 11% [https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/cost-federal-tax-reform-3-1-2018-cost-v2.pdf]. The authors of that report admitted, however, they did not take into account the state tax windfall generated by Alabama taxpayers' lower FIT deductions, as explained below.

The Task Force found no concern with state conformity to the TCJA Expanders in most instances. It did, however, identify three TCJA conformity items that present serious concerns for Alabama taxpayers.

1) **Limits on business interest deductions (IRC Section 163(j)). --** This provision limits the business interest deduction for any taxable year to the sum of: (1) business interest income; (2) 30% of the taxpayer's adjusted taxable income; and

(3) floor plan financing interest. Disallowed interest expense may be carried forward indefinitely to succeeding years.

For federal tax purposes, companies that are members of an affiliated group which meets certain stock ownership requirements can elect to file as consolidated groups. The proposed regulations under IRC Section 163(j) specify that this interest limitation is determined on a consolidated group basis for those affiliated groups which file federal consolidated returns. Generally, the interest limitation in IRC Section 163(j) is a reasonable calculation to discourage overleveraging of corporate groups, particularly if that overleverage is used to eliminate income tax liability by investing the borrowed money in assets whose cost can be immediately expensed. See IRC sections 168(k) and 179. For federal income tax purposes, most affiliated companies file as consolidated groups. However, with the exception of certain Alabama affiliated groups that can elect to file a consolidated return to report the Alabama apportioned income of those members with nexus in Alabama [see Ala. Code section 40-18-39(b)], Alabama law requires companies doing business in our state to file separate income tax returns.

The Task Force found it to be a common business practice for Alabama-headquartered companies and many other affiliated groups doing business in Alabama to borrow money at the parent company level and utilize the proceeds from the financing to fund operations for the entire consolidated group, including subsidiaries and joint ventures. This practice is common in the insurance, healthcare, energy and other regulated industries. For certain of these regulated industries, subsidiaries may be precluded from joining in the filing of an elective Alabama consolidated return due to the fact that they are taxed on a different basis at the state level. For example, insurance companies remit premium tax to the state of

Alabama and therefore do not file Alabama income tax returns. Though the consolidated group as a whole is not overleveraged and does not trigger the Section 163(j) limitation at the federal level, the separate parent company/borrower, when filing alone, often triggers the limitation on its Alabama return. That results from the fact that the return includes a significant amount of interest expense to outside lenders but only includes the income of the parent, rather than the income of all consolidated group members for which the debt was incurred. The Task Force found these common business practices not to be egregious and found an interest limitation applied on a separate company basis to be outside the spirit of the Federal legislation. It also found that multiple states are addressing this same concern. For example, Georgia and Tennessee have enacted decoupling legislation while Mississippi was already de-coupled and chose not to conform. The Florida legislature established a task force to study the issue.

The Task Force did not conclude that Alabama should decouple entirely from the IRC Section 163 (j) limitation and believes that Alabama should generally limit the interest expense deductions for overleveraged companies. The Task Force, however, did conclude that applying the limitation at a separate company level lacked conformity with the spirit of the federal legislation and creates a trap for the unwary company doing business in this state. Pennsylvania issued Corporation Tax Bulletin 2019-03 which the Task Force believes addresses the separate company issue in a reasonable and fair manner. The Task Force acknowledges that financial institutions are entirely exempt from the Alabama impact of IRC Section 163(j) because of legislation passed by the Alabama Legislature last year (discussed below), but that is logical due to the unique business and lending operations of financial institutions and the doubt whether the 1930's financial institution excise tax automatically incorporated IRC Section 163(j).

The Task Force believes the Legislature should consider modifying the impact of the Federal Section 163(j) limitation. The Legislature should consider adopting provisions to allow any Alabama corporate taxpayer that files as part of a Federal consolidated group to not be subject to the Section 163(j) limitation on its separate company interest expense deduction for Alabama tax purposes unless the Federal consolidated group is also subject to the interest expense limitation on the group's consolidated Federal Form 1120 for that same tax period. If the Federal consolidated group reports an interest limitation under IRC Section 163(j), the Legislature should consider adopting provisions allowing each member with an Alabama filing obligation to perform its own calculations on a separate company basis in order to determine if the interest expense limitation applies.

2) **Global intangible low-taxed income (GILTI) and offsetting deduction (IRC Sections 951A and 250). --** This provision states that a U.S. shareholder of any "controlled foreign corporation" (CFC) must include in its federal taxable income its pro-rata share of the CFC's GILTI. GILTI is considered the excess of the shareholder's net CFC income over the shareholder's net deemed tangible income. The IRC Section 250 offsetting deduction is only available to U.S. C corporations that are shareholders of CFCs. Eligible C corporation taxpayers can deduct 50% of the GILTI amount calculated under IRC Section 951A (reduced to 37.5% beginning in 2026).

The Task Force determined that Alabama appears to have limited exposure to U.S. shareholders that have direct ownership of any CFCs. Further, the Task Force acknowledges that there are serious questions about states' constitutional ability to impose a tax on foreign earnings [https://www.cost.org/globalassets/cost/state-tax-

resources-pdf-pages/cost-studies-articles-reports/state-taxation-of-gilti-policy-and-constitutional-ramifications.pdf]. A majority of the states have elected to decouple from the GILTI tax and only a handful of separate reporting states haven't decoupled already. See Appendix B. Also, especially since the enactment of the Financial Institution Excise Tax Reform Act of 2019 ("FIETRA"), banks are in close parity to corporate income taxpayers both in terms of calculating their taxable income and their 6.5% tax rate. FIETRA de-coupled our banking tax law from GILTI. Parity would dictate the same treatment for corporate income taxpayers.

The Task Force recommends the Legislature consider adopting measures to decouple Alabama income tax law from the provisions of GILTI.

3) The Tax Cuts and Jobs Act incorporated changes to Internal Revenue Code Section 118 which result in the taxation of certain state and local government economic development incentives, which are provided in the form of contributions to an economic development project. Through Alabama's rolling conformity provisions for corporate income tax, the state therefore automatically adopted these changes to Section 118, and thus certain economic development incentives granted by the state or local economic development authorities may now be subject to state income taxation. Since this indirect state-level taxation was not intended at the time the economic development incentives were granted, and it makes no sense for the state to tax its own or local authorities' incentives to new or expanding industries, the Task Force believes the state should decouple from the provision. The Task Force further notes that other Southeastern states such as North Carolina have recently adopted similar provisions.

Accordingly, the Task Force believes the Legislature should consider decoupling from changes to Internal Revenue Code Section 118.

Statutory Tax Rate and Federal Income Tax Deduction

Alabama is an outlier: it is one of only a few states that allows a deduction to corporations for their federal income taxes (FIT). Louisiana is the only other state that offers a full deduction. Missouri allows a 50% deduction. For individual taxpayers (including the owners of PTEs), only Alabama and Louisiana allow a full deduction, while Iowa is phasing its deduction out, and Missouri, Montana and Oregon allow only minimal deductions at low income levels. In order to determine the true effective tax rate in Alabama, one must perform a simultaneous equation with state income taxes deducted in the federal tax calculation and FIT deducted in the state income tax calculation.

For federal corporate income tax purposes, the TCJA reduced the federal tax rates from a top rate of 35% to a flat 21%. This change automatically results in a dramatic increase in the effective corporate tax rate in Alabama. As mentioned above, the EY Study did not take reduced FIT deductions into account in predicting that Alabama businesses would pay somewhere between 11-12% more Alabama income tax as a result of the TCJA. The Task Force considered the calculations of Alabama corporate income taxes for multiple common scenarios and found that the combination of continued conformity with the Expanders associated with the TCJA and the reduced FIT deduction as a result of companies' reduced FIT liability increased the Alabama income tax burdens for most Alabama corporate filers by 19% or more.

For PTEs, the TCJA introduced a 20% deduction of Qualified Business Income (QBI), intended to provide individual PTE owners with limited tax relief similar to that enjoyed

by C corporations due to their dramatic tax rate reduction. See IRC Section 199A. Alabama does not conform with this beneficial provision, nor do most other states. The Task Force considered the preliminary calculations of Alabama PTE owners' individual income taxes for common scenarios and found that the combination of the Expanders associated with the TCJA , the substantially reduced FIT deduction, and the state's nonconformity with the TCJA's QBI/Section 199A deduction, increased the Alabama income tax burden for most individual PTE owners by an amount ranging from 5-13%.

Outside of the QBI deduction for individual PTE owners (which Alabama does not follow), the Task Force noted few changes in the TCJA that substantially affected the determination of taxable income for Alabama individual taxpayers. However, the TCJA was designed to give almost every taxpayer some federal tax reduction through a combination of lower tax rates and increased federal standard deductions and federal tax credits. Because of the reduced FIT deduction alone, Alabama correspondingly imposed varying amounts of tax increases.

The Task Force considered Alabama's current FIT deductibility and made the following observations:

1) Reduced federal income taxes, especially when coupled with the above-mentioned Expanders, result in a substantial windfall to the ETF and a corresponding substantial tax increase on the business taxpayers of Alabama.

2) The combination of a relatively high corporate tax rate (Alabama's corporate rate of 6.5% is higher than surrounding states) and the FIT deduction masks Alabama's favorable effective tax rates. For example, an Alabama-based corporation taxable only by this state had an effective income tax rate of 4.3%

prior to TCJA and 5.2% after the TCJA. This compares with 6.5% in Tennessee, 5.75% in Georgia, 4.458% in Florida and 5.0 % in Mississippi and South Carolina. Alabama's statutory individual income tax rate of 5% is effectively only 3.2-4.7% when the FIT deduction is factored in. This compares with 0% in Tennessee, 5.75% in Georgia, 0% in Florida, 5% in Mississippi and 7% in South Carolina. See the *Income Tax Rate maps* published by the *Tax Foundation* [https://taxfoundation.org/]. Alabama gets little to no credit for its lower effective tax rates resulting from the FIT deduction. We are advised that it is a meaningful competitive disadvantage in state comparisons by economic developers and companies looking to locate in the Southeast. Alabama will never know how often it has been "deselected" in a business location decision because it is perceived to have one of the highest corporate income tax rates in the Southeast.

3) Alabama's FIT deduction has been referred to as an inverted and distorted mirror. When federal income taxes go down, Alabama's income taxes go up. When federal income taxes go up, Alabama's go down. When the federal tax system provides a preference or incentive for something, Alabama taxes it. When the federal system penalizes an activity, Alabama in effect subsidizes it.

4) For individual taxpayers, because of the graduated federal tax rates, i.e., lower amounts of income are taxed at lower federal tax rates and higher income at higher federal tax rates, the inverted Alabama tax system is regressive. Alabama taxes its lowest earning taxpayers at the highest effective tax rates. Alabama taxes its highest earning taxpayers at the lowest effective tax rates.

5) The FIT deduction subjects Alabama to a volatility factor that is completely out of its control. Though the ETF is enjoying the windfall of today's federal tax reductions, it is positioned to be whipsawed by any federal tax increases in the future. Forty-eight of the other states do not subject their budgets to this volatility.

6) This is the time. If Alabama is to ever deal with the previous observations, it would want to do so when federal income taxes are likely at their lowest. This is uniquely the one time Alabama could eliminate the FIT deduction, reduce its statutory tax rate, assure that the ETF maintains revenue higher than pre-TCJA levels, and grant Alabama businesses and their owners a reduction in income taxes versus post-TCJA burdens.

The Task Force recommends the Legislature consider eliminating the corporate and financial institution FIT deduction while correspondingly reducing the statutory and constitutional corporate and FIET 6.5% tax rate to one that provides a higher effective tax rate than pre-TCJA (to assure retention of a substantial portion of the revenue windfall to the ETF), lower than the effective tax rate post-TCJA (to ensure that Alabama corporations see a reduction in their effective post-TCJA Alabama tax increase) and lower than surrounding southeastern states (to ensure Alabama's competitive position for the future). The Task Force's research indicates that a 4.75% statutory tax rate will accomplish these objectives.

The Task Force also recommends the Legislature address the regressive nature of the state income tax for individuals and consider measures, including eliminating the FIT and reducing individual tax rates. The Legislature should also consider

modifying other taxes in order to improve the fairness and lessen the regressive nature of Alabama's taxes on individuals.

In contrast to the impact on corporate taxpayers in Alabama, the Task Force determined that the impact on individual taxpayers in Alabama is much less significant on a per-taxpayer basis, and the amount of the impact varies considerably based on individual circumstances. However, almost every Alabama taxpayer has experienced a post-TCJA Alabama tax increase. Most concerning, the combination of the FIT deduction and the federal graduated tax rate system is regressive and simply unfair as it imposes the lowest effective tax rate on the taxpayers with the highest income and imposes the highest effective tax rate on the taxpayers with the lowest income.

Additionally, the Task Force notes that the current reduction in federal individual income taxes is only temporary in nature, as the majority of the favorable individual tax provisions in the TCJA are only effective for calendar years 2018-2025 and are set to expire on December 31, 2025. Certain of the favorable provisions, such as the accelerated bonus depreciation provisions, will begin to sunset in earlier years, such as 2023. Accordingly, the impact on the FIT deduction for Alabama individual taxpayers could continue for only a limited number of years, and absent action by Congress, individual taxpayers will return to the pre-TCJA level of federal tax by January 1, 2026. Therefore, it would be in the ETF's best interest to deal with its volatility and regressive tax system issues now.

The Task Force notes that the arguments regarding a tax windfall for the ETF and related tax increase for Alabama business taxpayers, the masking of favorable effective rates, the inverted and distorted mirror effect, the regressive nature of the Alabama individual tax system and the consequent volatility to the ETF

budget, compel action. Eliminating the FIT deduction and lowering the statutory tax rate appears to be an appropriate response. The Task Force's initial research indicates a rate between 3.95% to 4.25% would achieve this objective. However, in consideration of the magnitude of individual tax revenues to the ETF and the complexity of determining the budgetary impacts, the Task Force concluded it did not have sufficient funding or time to arrive at a specific recommended individual statutory tax rate, as of the writing of this report.

Apportionment of Multistate Business Income

States allocate business taxable income to individual states for taxation based on apportionment factors. It is not a zero-sum game, though. Due to differences in the apportionment methodologies utilized by the states, multistate businesses often pay tax on less than 100% of their income, but increasingly pay tax on more than 100% of their income. Each state selects its own method and those methods vary not only between states but as between specific industries. For example, Alabama like most states has a separate and unique apportionment formula for financial institutions, telecommunications companies, railroads, and construction contractors. Apportionment formulas are key considerations in determining where to form or locate a business and are central to how states present themselves to the business community and industrial recruiters. For example, Georgia's promotional literature, *Georgia USA Business Incentives 2019*, dedicates one half of the first page to its Single Factor Apportionment method.

Alabama generally uses a three factor apportionment formula (Sales, Property, and Payroll) in which the sales factor is double-weighted. Alabama couples this formula with a "throwback" provision which treats sales to states where the filer has no nexus (filing obligation) as deemed Alabama-sourced sales.

In contrast, Georgia has a Single Sales Factor formula, with no throwback. In effect, Georgia offers a huge incentive for its companies to sell their goods and services to out-of-state or international customers, since those sales are not taxed by Georgia.

Tennessee utilizes a three factor apportionment formula in which the sales factor is triple-weighted, with no throwback (except for U.S. government sales).

Florida has the same apportionment formula as Alabama, but with no throwback.

Mississippi has designated formulas for certain industries, as do most other states, but generally has a Single Sales Factor formula, with throwback.

South Carolina has a Single Sales Factor formula, with no throwback.

Twenty-seven states have a Triple or Greater-weighted or Single Sales Factor apportionment method. Twenty-four states have either no throwback or limited throwback for only U.S. government sales.

With Alabama's generally double-weighted sales factor apportionment formula, every new investment in property, plant and equipment, every new headquarters facility or technology investment, and every new employee added to the Alabama payroll, increases the Alabama apportionment factor and thus the Alabama income tax burden. And that's a burden that wouldn't be incurred if the company located in Georgia or South Carolina. Businesses that sell nationally or internationally are incentivized to locate outside of Alabama. Suppliers to Alabama's large automotive assembly plants are incentivized to locate on the other side of the Alabama line, as did Kia Motors. The

Single Sales Factor method is generally favorable for businesses that headquarter or have domiciled operations in-state and unfavorable for those who headquarter and domicile large operations elsewhere but sell into the state.

Accordingly, the Task Force recommends that Alabama consider adopting a Single Sales Factor apportionment method for non-specialized industries and eliminating its current throwback provisions in order to be more comparable and competitive with other Southeastern states.

Unitary Combined Reporting

With unitary combined reporting, the business income of corporate members of a unitary group is combined, intercompany transactions are eliminated, and the combined business income is apportioned among the states based on group-level apportionment percentages. Combined reporting is considered to be effective in addressing tax planning in which businesses shift income to low- or no- tax jurisdictions, such as creating a subsidiary in Nevada to handle bond transactions or moving a trademark to a Delaware subsidiary and licensing it back. Twenty-three states have adopted combined reporting, though none in the southeastern U.S.

The Task Force explored this concept with the many constituents mentioned earlier in this report. Particularly of note is the Alabama Department of Revenue's belief that Alabama's add-back provisions and intercompany transfer pricing restrictions and the audit process are effective in addressing the concern of abusive tax planning. The Task Force found no appetite for combined reporting from either government officials or the taxpayers.

The Task Force believes that Alabama should not adopt unitary combined reporting.

Pass-Through Entities and their Owners

As mentioned above, the TCJA introduced a Qualified Business Income (QBI) deduction of 20% for PTE's, primarily to provide the individual owners of PTE businesses with federal tax reductions similar to those enjoyed by C corporations. See IRC Section 199A. This reduction in FIT for individual PTE owners with QBI resulted in a corresponding increase in Alabama income tax due again to the interplay with the FIT deduction. The Task Force's above recommendation to eliminate the FIT deduction and correspondingly lower the individual tax rate addresses this concern in large part.

Some states (approximately 6) have adopted a QBI deduction for state income tax purposes. This approach is particularly meaningful in states that have a disparity in their corporate and individual tax rates, where individual rates are higher. This is not the case in Alabama, and the calculation of this deduction is highly complex; accordingly, the Task Force did not explore this idea further.

However, the Task Force did find that the PTE community in Alabama and their tax advisers are deeply concerned about the TCJA's controversial limitation on the deductibility of one's state and local taxes (SALT), often called the "SALT cap." IRC Section 164(b)(6). The TCJA imposes a $10,000 (for married taxpayers filing jointly; otherwise, $5,000) annual limit on deducting SALT on our federal tax returns, which covers state and local income and license taxes, ad valorem property taxes, sales/use taxes, etc. Once one considers state and local property taxes on their home, farm, business equipment, investment property, etc. and state income and occupational taxes on salary and wages, most (and in some cases, all) business-related Alabama state and local taxes are rendered not deductible on the federal tax returns of PTE

shareholder/partners even though they receive and could otherwise deduct a pro rata share of their PTE's SALT expenses.

The Internal Revenue Service used this same SALT cap provision to attack tax credit scholarship programs for low income families, such as the one offered in Alabama and similarly in at least 16 other states. In those longstanding programs, the corporate or individual donor could claim a charitable contribution deduction on their federal tax return and receive a state or local tax credit at the same time. The IRS' efforts caused significant confusion and drop-off in donations last year to these non-profit organizations, including the state's scholarship-granting organizations, such as the Alabama Opportunity Scholarship Fund (AOSF) and Scholarships for Kids (SFK).

Many states are addressing this concern with various approaches to achieve the objective of ensuring parity between PTEs and corporations with respect to SALT deductions. The Task Force believes that business-related state income tax and other SALT incurred by Alabama PTEs should rightfully be deductible for federal income tax purposes by their owners. Also, businesses should be able to donate to tax credit scholarship programs and continue to claim a federal business expense deduction and state tax credit for the donation. PTE businesses and their owners should be treated equally.

Accordingly, the Task Force suggests the Legislature consider allowing an election for PTEs doing business in the state whereby the PTE may elect to pay their Alabama income tax at the entity-level, so that the tax (and the income) would not flow through to the individual owners and then be subjected to the $10,000 SALT cap. The Task Force recommends that the provisions for the election incorporate the appropriate safeguards to ensure that these provisions are revenue-neutral.

Activities in Other States

Monitoring the activities of all the other states in their various responses to the TCJA is beyond this Task Force's charge and resources. However, the Task Force did note various state TCJA responses that it found informative and worthy of mention in this report.

Missouri took a comprehensive approach to its TCJA response. It phased-out the FIT deduction for certain individuals with higher income levels and correspondingly lowered their tax rates. It changed its apportionment method to a Single Sales Factor with no throwback. It created an IRC Section 199A-like qualified business income deduction of up to 20% for individual PTE business owners. This made sense in Missouri where the individual tax rate is higher than the corporate tax rate. Missouri retained its one-half corporate deduction for FIT.

Iowa also took a comprehensive approach to its TCJA response. Iowa installed triggers- reforms that take place only if certain revenue targets are achieved. Iowa is repealing the FIT deduction for both individuals and corporations and lowering tax rates. It is also phasing-in a partial Section 199A qualified business income deduction for individual PTE owners.

In response, Georgia reduced its corporate tax rate from 6% to 5.75% and is moving to 5.5% this year. Since Georgia has no FIT deduction, this move was made in anticipation of the Expanders' effect and for economic stimulus and competitiveness.

Florida is likewise reducing corporate tax rates based on a triggering formula and recently announced a new lower corporate tax rate of 4.458%. Reported tax

collections indicate there will be continuing tax rate decreases. Again, Florida has no FIT deduction, so these rate reductions would be for Expanders, economic stimulus and competitiveness.

North Carolina, though only partially related to TCJA, uses a triggering system based on taxes collected and has reduced its corporate income tax rate from 6.9% in 2013 to 2.5% in 2019. North Carolina does not have the FIT deduction and these rate decreases are for economic stimulus and competitiveness.

Louisiana's Governor in 2019 proposed the repeal of their constitutionalized FIT deduction for both corporate and individual taxpayers and the corresponding lowering of tax rates. These ideas were included along with other more controversial proposals such as expanding the sales tax base and adding a minimum tax based on gross receipts. A *Baton Rouge Advocate* editorial said the proposals "succumbed to political stasis and partisan infighting".

In January, South Carolina's governor proposed legislation which included $428.5 million in tax breaks in the spending plan for the upcoming fiscal year. The proposed tax breaks include $250 million in tax rebates for South Carolina citizens, with the amount of each taxpayer's rebate determined in reference to the tax previously paid by the taxpayer. The average tax rebate is projected to be $204. Additionally, the Governor proposed a 1% reduction in personal income tax brackets, which would be phased-in over a five-year period, and an exemption for the retirement income of military veterans and emergency responders.

Competitiveness

The Task Force considered *the 2020 State Business Tax Climate Index* compiled by Jared Walczak of the Tax Foundation in Washington, DC [https://taxfoundation.org/2020-state-business-tax-climate-index/]. Alabama's 2020 ranking is #40.

Below are several excerpts the Task Force found particularly informative for Alabama:

- "Taxation is inevitable, but the specifics of a state's tax structure matter greatly".
- "The modern market is characterized by mobile capital and labor, with all types of businesses, small and large, tending to locate where they have the greatest competitive advantage. The evidence shows that states with the best tax systems will be the most competitive at attracting new businesses and most effective at generating economic and employment growth".
- "Furthermore, unlike changes to a state's health-care, transportation, or education systems, which can take decades to implement, changes to the tax code can quickly improve a state's business climate."
- State lawmakers are mindful of their states' business tax climates, but they are sometimes tempted to lure business with lucrative tax incentives and subsidies instead of broad-based tax reform."
- "This means that state lawmakers must be aware of how their state's business climates match up against their immediate neighbors and to other regional competitors."

This Task Force has attempted to take these admonitions into account and to propose changes to Alabama's tax policies that are practical and fair, while improving Alabama's overall competitive position.

Acknowledgements

Senator Dan Roberts and Representative Danny Garrett wish to express their gratitude to all those who contributed in one way or another to the work of the Joint Legislative Task Force on the Tax Cuts and Jobs Act (SJR 87). Their tireless and altruistic service to our State is most appreciated.

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Along with numerous other companies and tax professionals who worked diligently in pulling this report together.

Appendices

Appendix A: Senate Joint Resolution 87 (Act 2019-339)

Appendix B: PowerPoint Presentation

Appendix A:

Senate Joint Resolution 87 (Act 2019-339)

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SJR _____ ESTABLISHING THE JOINT LEGISLATIVE TASK FORCE ON THE TAX CUTS AND JOBS ACT.

WHEREAS, the Tax Cuts and Jobs Act enacted changes across-the-board to the federal tax system; and

WHEREAS, the across-the-board changes will impact the amount of federal taxes paid by individual corporations differently depending on the structure of the corporation; and

WHEREAS, the computation of Alabama corporate income tax begins with federal taxable income; and

WHEREAS, Alabama allows various adjustments to federal taxable income, one of which is a deduction for federal income taxes paid or accrued; and

WHEREAS, the net impact of federal tax changes on Alabama corporate income taxes cannot be determined without considering all of these adjustments; and

WHEREAS, an initiative is necessary to further explore the fiscal impact of the Tax Cuts and Jobs Act as it relates to Alabama corporate income tax; now therefore,

BE IT RESOLVED BY THE LEGISLATURE OF ALABAMA, BOTH HOUSES THEREOF CONCURRING, That a Joint Legislative Task Force on the Tax Cuts and Jobs Act is established to study the fiscal impact of the act on corporate income tax in this state.

(a) The task force shall be composed of the following members:

(1) Three members of the House of Representatives appointed by the Speaker of the House, one of whom must be a member of the minority caucus in the House.

(2) Three members of the Senate appointed by the President Pro Tempore of the Senate, one of whom must be a member of the minority caucus in the Senate.

(b) The task force shall evaluate and analyze the effects of the Tax Cuts and Jobs Act on Alabama corporate income taxes including, but not limited to: Research, compilation of information, and preparation of fiscal analyses of the effects of the Tax Cuts and Jobs Act on Alabama Corporate Income Tax. The fiscal analyses shall include the various deductions and adjustments that are made to federal taxable income for purposes of the Alabama corporate income tax.

(c) In performing the duties prescribed by this resolution, the task force may consult with the Legislative Services Agency and other governmental and private sector subject matter experts.

(d)(1) The Speaker of the House and the President Pro Tempore of the Senate shall call the first meeting of the task force, which must be held not later than September 30, 2019. The task force shall elect a co-chair from the House of Representatives and a co-chair from the Senate at its first meeting. Upon the request of the co-chairs, the Clerk of the House and the Secretary of the Senate shall provide necessary clerical assistance for the work of the task force.

(2) The task force shall meet monthly or as otherwise determined by the co-chairs and shall report its findings, conclusions, and recommendations to the Legislature not later than the fifth legislative day of the 2020 Regular Session, whereupon the task force shall stand dissolved and discharged of any further duties and liabilities.

(e) Each member of the task force shall be entitled to his or her regular legislative compensation, per diem, and travel expenses for each day he or she attends a meeting of the task force in accordance with Amendment 871 of the Constitution of Alabama of 1901. These payments shall be paid out of any funds appropriated to the use of the Legislature by means of warrants drawn by the state Comptroller on the State Treasury.

Appendix B:

PowerPoint Presentation

Alabama Joint Legislative Task Force on the Tax Cuts and Jobs Act

February 2, 2020 Discussion Deck

News Coverage

- http://abc3340.com/news/local/lawmakers-federal-tax-cuts-caused-alabama-tax-rates-to-rise

Alabama is now 1 of 2 states where you can fully deduct your Federal Income Tax on your State Tax return. Because Federal Income Tax went down, that means you have less to deduct from your State Taxable Income, therefore, you pay more to Alabama.

State Taxable Income

- Lower Federal Tax

More Paid in State Taxes

TCJA increases states' corporate taxable income with the following, called EXPANDERS

- Net interest expense limitation, 163(j), +
- Bonus depreciation, timing –
- Like kind exchange limitations, +
- Domestic dividend received deduction reductions, +
- Amortization of research & development, timing +
- Repeal of domestic production deduction, +
- Change in the global taxation scheme (GILTI, FDII, BEAT), +
- ALL WHILE REDUCING THE RATE FROM 35% TO 21%
- E&Y estimates the effect of the EXPANDERS to be 11% for Alabama

Competing states are on the move

- Georgia: Reduced rates from 6% to 5.75%, on way to 5.5% in 2020
- Florida: Reducing rates based on a triggering formula starting at 5.5%, approximately $500 million refund expected in 2019 for 2018 overcollections
- North Carolina: Using a triggering system since 2014, has lowered its corporate tax rate from 6.9% to 2.5%
- Missouri: Reducing rate from 6.25% to 4.0%
- Iowa: Repealing the FIT deduction, was ½, and reducing rates from 12% to 9.8%
- Arkansas: Reducing rates from 6.5% to 5.9%
- Virginia: Sequestered any new revenue gained for 2018 until policy decisions can be made.

Alabama is an outlier in that it is one of the few states that allows a Federal Income Tax Deduction

- For corporate taxation: Louisiana (full), Missouri (half)
- For individual taxation: Louisiana (full), Iowa (in process of phasing out), Missouri (small cap), Montana (small cap), Oregon (limited to lower tax brackets)

Remember simultaneous equations?
To determine the true effective rate for a taxpayer in Alabama requires a simultaneous equation.

CORPORATE

$Taxable\ income$

-State taxes

Federal Taxable income

X .21

Federal Taxes

Taxable income

-Federal taxes

X .065

State taxes

INDIVIDUAL

Taxable income

-State taxes (Complicated by SALT limitation and standard deduction)

Federal Taxable income

X .22, .24, .32, .35, .37

Federal Taxes

Taxable income

-Federal taxes

X .05

State taxes

So what does the math yield for Alabama taxpayers?

CORPORATE

PRE-TCJA
Federal 33.5%
Alabama 4.3%

POST-TCJA
Federal 19.9%
Alabama 5.2%

INDIVIDUAL, married filing jointly, with taxable income of say $125,000

PRE-TCJA
Federal 24.0%
Alabama 4.1%
POST-TCJA
Federal 21.1%
Alabama 4.23%

INDIVIDUAL, married filing jointly with taxable income of over $612,000

PRE-TCJA
Federal 38.4%
Alabama 3.15%
POST-TCJA
Federal 35.8%
Alabama 3.26%

Observation 1- The result of the corporate expanders and reduced federal income taxes

Windfall for the Education Trust Fund

Tax increase on the taxpayers of Alabama

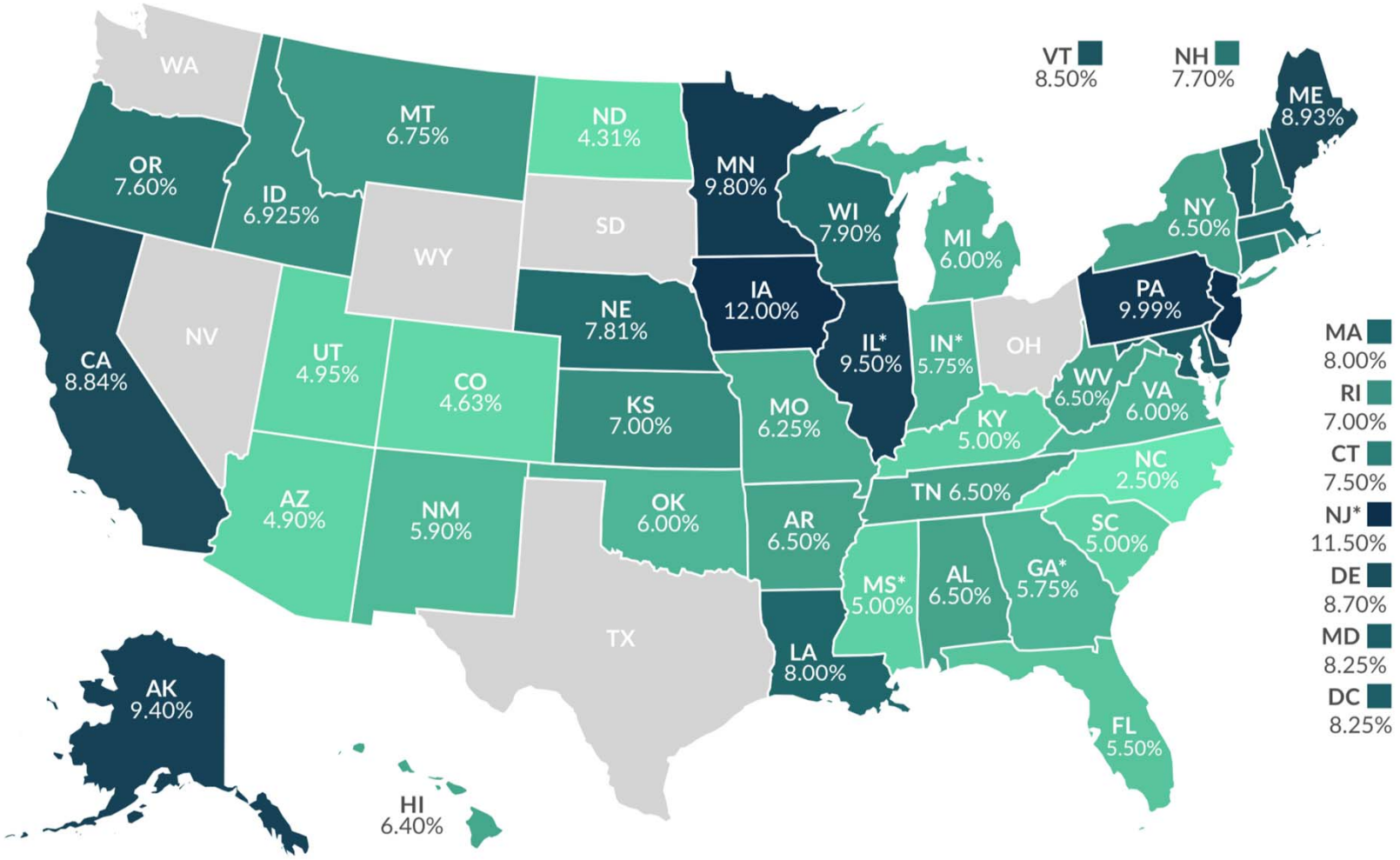
Observation 2- Masking Effect

The Federal Income Tax Deduction on the Alabama Return/ Higher Statutory Income Tax Rate Combination MASKS Alabama's relatively low rates of 5.2% (previously 4.3%) for corporate and 3.2% - 4.23% for individuals.

Coupled with Alabama's low property taxes, Alabama has a compelling story to attract business and workers.

The FIT deduction/high rate combo creates an **OPTICS PROBLEM**

Top Marginal Corporate Income Tax Rates as of January 1, 2019

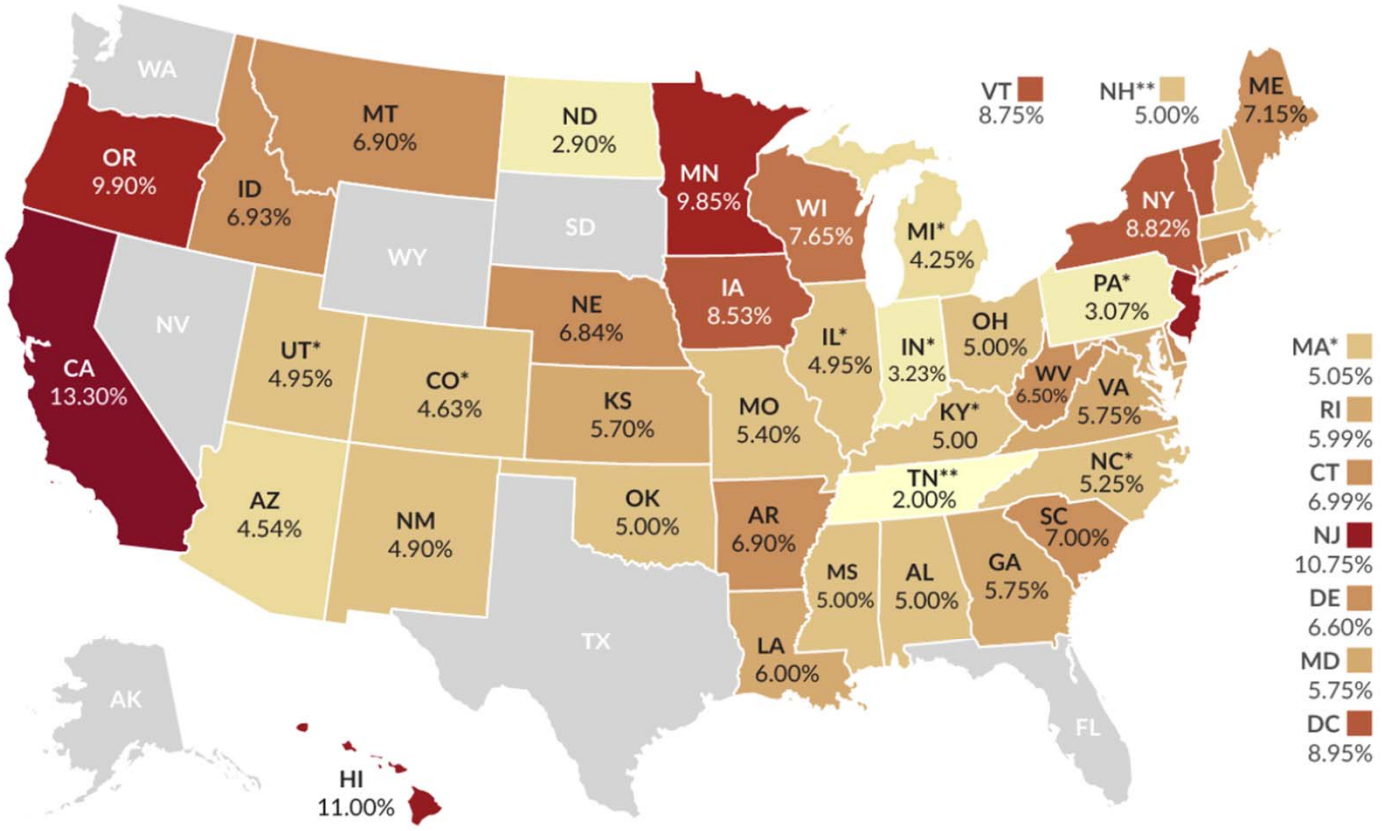


Note: (*) Nevada, Ohio, Texas, and Washington do not have a corporate income tax but do have a gross receipts tax with rates not strictly comparable to corporate income tax rates. Delaware has gross receipts taxes in addition to corporate

Top State Marginal Corporate Income Tax Rate

How High Are Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates, 2019



Note: (*) State has a flat income tax. (**)State only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.

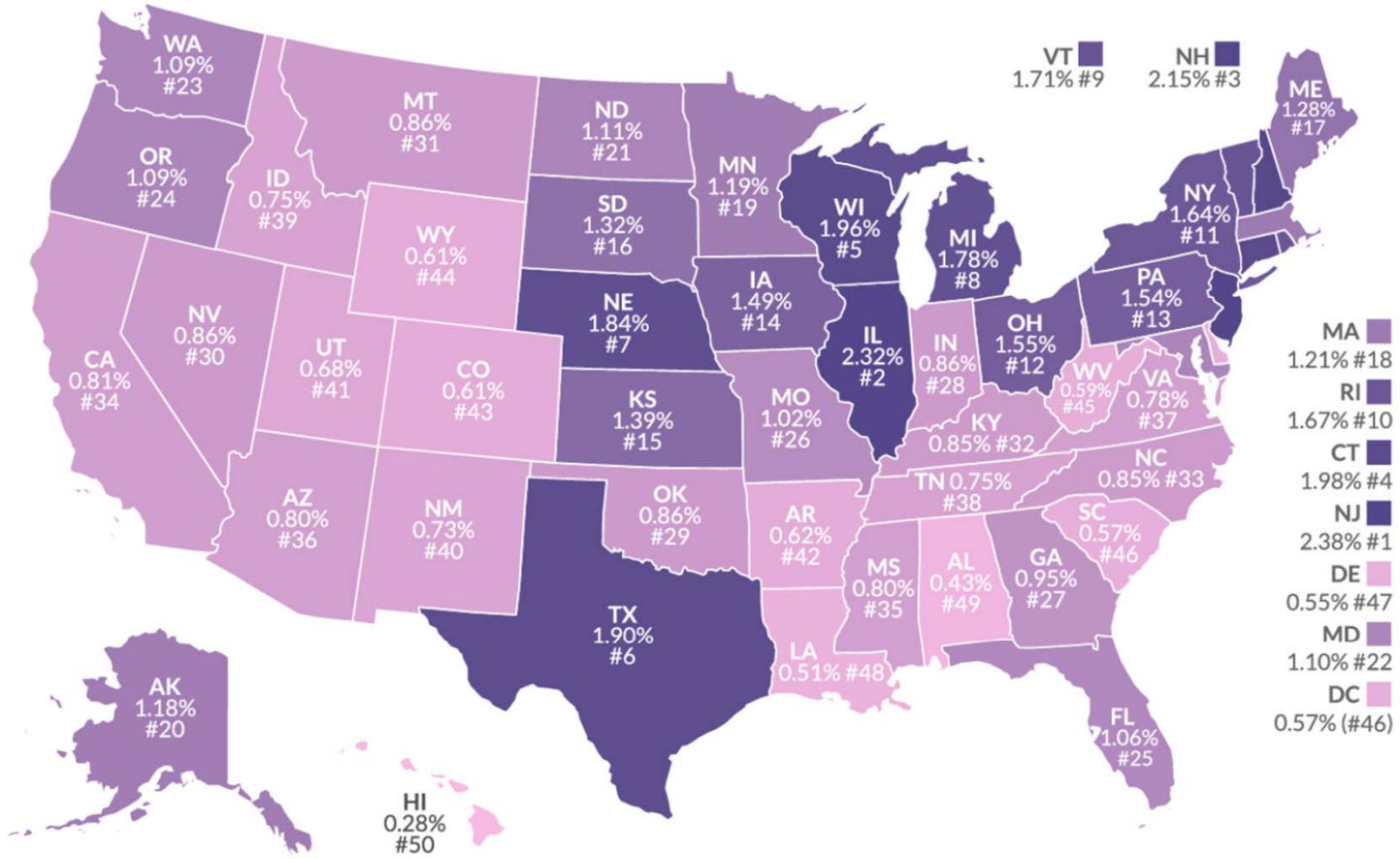
Source: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

Top State Marginal Individual Income Tax Rate

Lower — Higher

How High Are Property Taxes in Your State?

Mean Effective Property Tax Rates on Owner-Occupied Housing



Notes: The figures in this table are mean effective property tax rates on owner-occupied housing (total real taxes paid divided by total home value). As a result, the data exclude property taxes paid by businesses, renters, and others. D.C.'s rank does not affect other states' rankings, but the figure in parentheses indicates where it would rank if included.

Source: U.S. Census Bureau; Tax Foundation.

Effective Property Tax Rate

Lower Rate — Higher Rate

Observation 3- Inverted and distorted mirror

- When federal taxes go down, Alabama's go up. When federal taxes go up, Alabama's go down.
- When the federal system provides a preference or incentive for something, Alabama taxes it.
- When the federal system penalizes an activity, Alabama subsidizes it.

Observation 4- Regressive Effect for Individuals

- This phenomenon is a function of the graduated federal tax system.
- Middle class single workers with taxable income $39,000- $84,000 and married filing jointly with taxable income $79,000-$168,000 are paying a 3.95% effective rate while high income earners are paying a 3.2% effective rate.

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Observation 5- Budget Volatility

- Alabama's revenue system is more dependent on income taxes than many of its peer states.
- The FIT deduction feature introduces a volatility factor that is completely outside of Alabama's control.
- While enjoying the benefit today of federal tax reductions, the state's budget is positioned to be whipsawed by federal tax increases in the future.

Observation 6- This is the time

- If the state desires to deal with observations 2-5, it would want to do so when federal taxes are at their lowest.
- Eliminating the Federal Income Tax deduction requires Constitutional Amendment.
- The windfall generated by the Expanders and the lower federal income taxes could allow effective rate reductions for most taxpayers/ voters while positioning the state for future competitiveness.

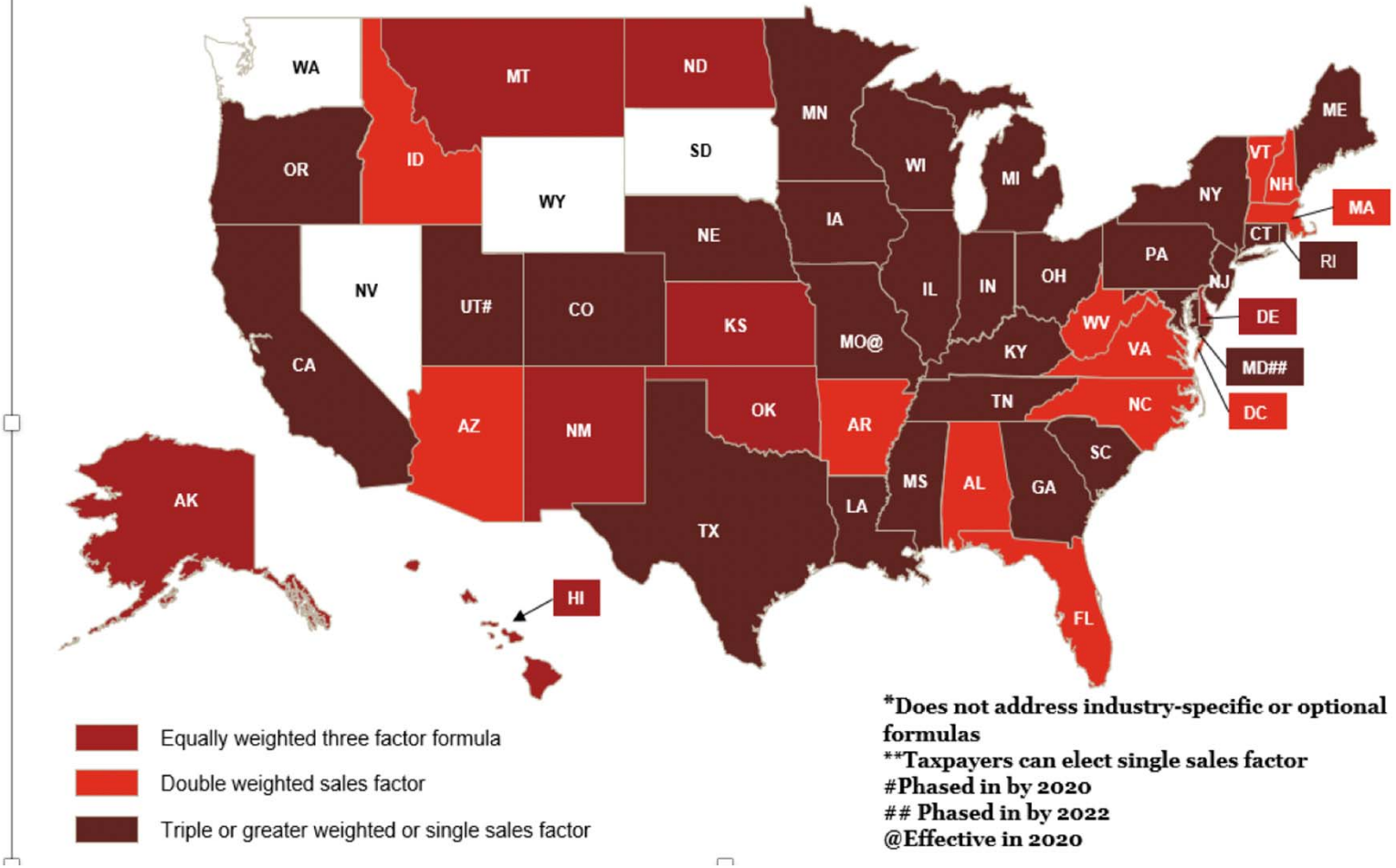
Strategy for FIT deduction and statutory rates

- Eliminate the FIT deduction. It is a peculiarity without a purpose.
- Protect the ETF budget by assuring that new rates allow the ETF to keep a piece of the windfall/ tax increase
- Establish new statutory rates that provide most taxpayers a lower effective tax rate than they pay today and eliminate the regressive nature of Alabama's individual income tax system
- Assure future competitiveness with corporate rates that are lower than surrounding states and individual rates that are attractive in comparison to most competing states

Businesses' taxable income is allocated to states based on apportionment factors

- Alabama uses a four factor apportionment formula (Sales, Property, and Payroll) with Sales double-weighted. Alabama also has throwback provisions where it treats sales to states with no nexus as Alabama sales.
- Alabama is surrounded by states that are either Single Factor Sales (destination sales only) or Triple Sales Factor apportionment states.
- Every new investment in property or new employee added increases Alabama's tax burden on a domiciled business.
- Businesses that sell nationally or internationally are incentivized to locate in Alabama's neighboring states
- Suppliers to Alabama's large assembly plants are incentivized to locate on the other side of the Alabama line.

Apportionment formulas*- 2018



Throwback States- States that include “nowhere” sales in their sales apportionment factor

- **YES**

- Alabama
- Mississippi

- **NO**

- Tennessee
- Georgia
- Florida
- South Carolina
- North Carolina

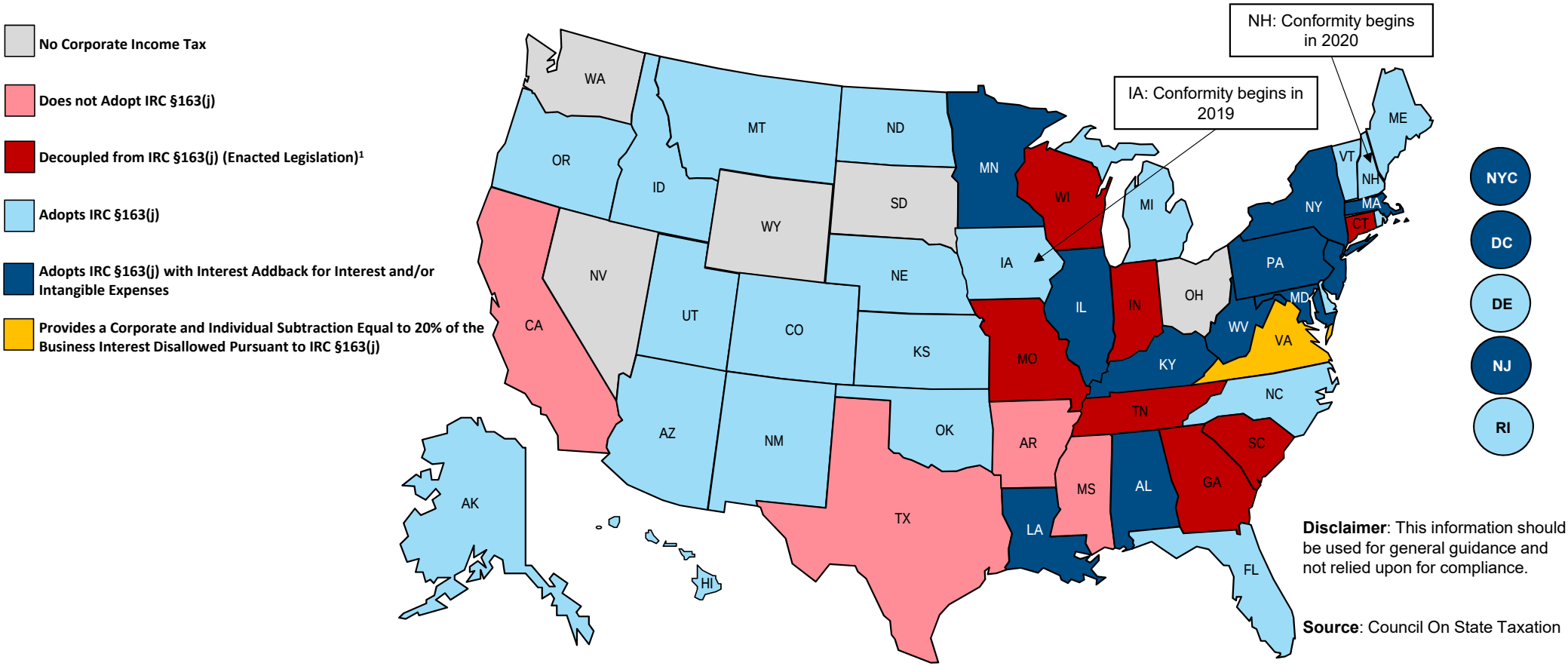
Strategy for Apportionment Formula

- Change to Single Factor Destination Sales (without throwback)
- Eliminate Alabama's competitive disadvantage versus surrounding states.
- This proposal is generally popular with Alabama domiciled companies and unpopular with non-domiciled companies.

Net Interest limitation 163(j)

- Alabama requires companies to file as separate companies, although nexus consolidated returns also allowed.
- For federal purposes, companies file as consolidated groups.
- TCJA proposes a net interest limitation at the consolidated level- Earnings before interest and taxes (EBIT) X 30%. This feature addresses overleverage of consolidated groups. We will use EBITDA (adding back depreciation, depletion, and amortization as well) until 1/1/2022
- When applied on a separate company basis, it yields some peculiar results.
- Alabama headquartered companies often borrow at the parent level and invest the funds in their subsidiaries or joint ventures. This practice is common and natural for the insurance, healthcare and energy industries. These companies are experiencing the 163 (j) limitation though they are not considered overleveraged.

IRC §163(j) Interest Expense Limitation: State Corporate Income Tax Conformity



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation

[1] May have state interest expense adjustments for related-party interest and/or intangible expenses.

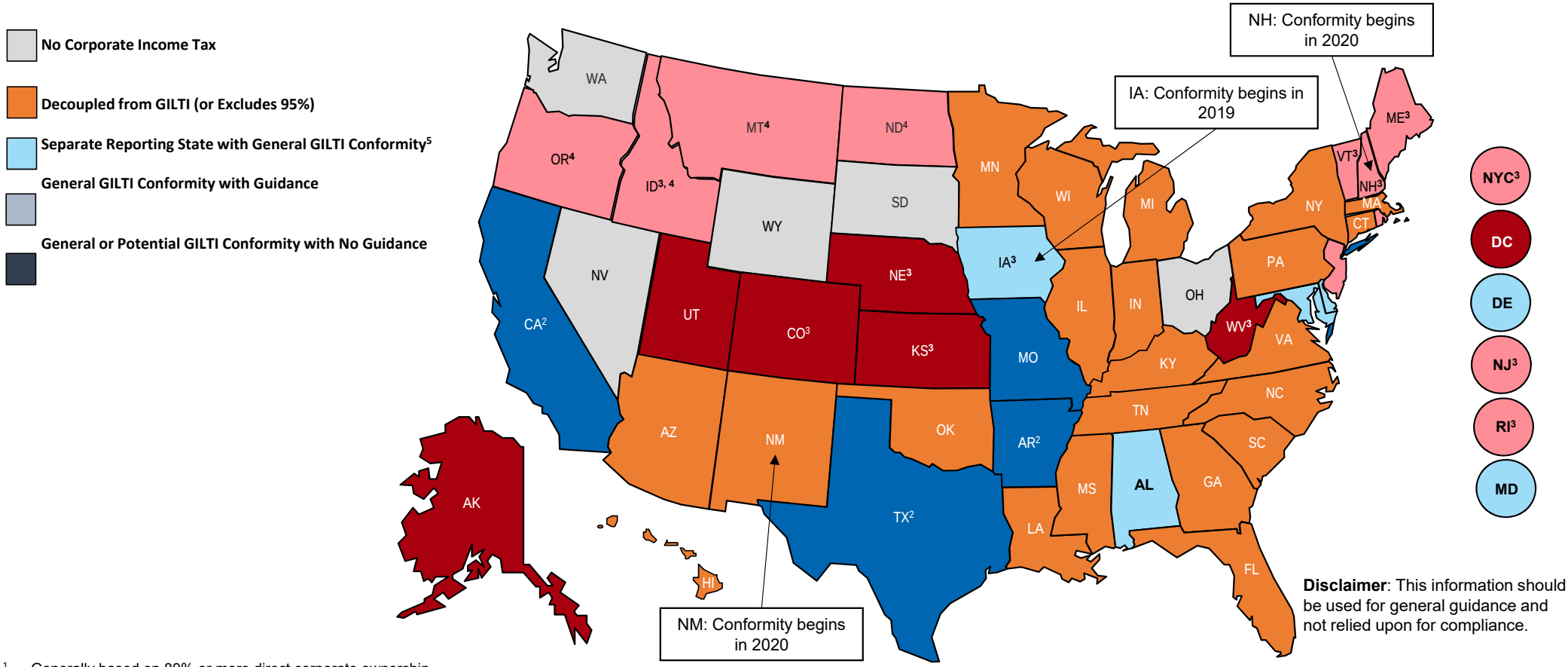
Strategy for 163 (j)

- Look to the federal return to see if there is a 163 (j) limitation.
- If there is not a consolidated limitation, then there is not a separate company limitation in Alabama.
- If there is a consolidated limitation, then calculate the Alabama limitation separately.

Global Intangible low-taxed income (GILTI)

- This provision of TCJA addresses the placement of intangible property around the world to minimize US taxation.
- There are serious reservations as to whether Alabama has the authority to impose taxes on foreign income.
- Only the entities that directly hold the controlled foreign corporations are subject to GILTI. Alabama appears to have minimal filers meeting this description.
- Many states have already de-coupled from GILTI or limited the amount imposed under GILTI.

GILTI: State Corporate Income Tax Conformity[1]



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation

1 Generally based on 80% or more direct corporate ownership.

2 Has not addressed IRC conformity and/or GILTI coupling specifically. Neither GILTI nor the § 250(a) deduction currently applies

3 Less § 250(a) deduction or state deduction in accordance with § 250(a).

4 State dividends received deduction (DRD) applies – GILTI amounts are eligible for Oregon's 80% DRD, Montana's 80% DRD, Idaho's 80% or 85% DRD, and North Dakota's 70% DRD.

5 GILTI inclusion may be constitutionally prohibited in separate reporting states. Note New Jersey was a separate reporting state for 2018. Additional state administrative guidance may have been provided.

Strategy for GILTI

- De-couple

IMPACT OF TCJA $10,000 SALT CAP ON PASS-THROUGH ENTITIES

•Married individuals now can't deduct over $10,000 in state and local income, property, sales/use taxes, etc. (SALT) which they pay during the year
•Pending litigation by several high-tax states and numerous "SALT cap workarounds" are being developed
•PTEs (Pass Through Entities - S corp's, LLC's, LP's, etc.) and their individual owners hit hard by the cap
•Example: Anne Smith and Richard Jones each own 50% of A&R Consulting, LLC (a PTE), which incurred $50,000 of SALT in 2019. So Anne and Richard can deduct $25,000 each on their personal tax returns? Nope- only $10,000 (if Married Filing Jointly - MFJ), plus they lose all their *personal* SALT deductions (e.g., property tax on their personal home or farm).
•Also, IRS says this same cap limits individuals' donations to qualified SGOs (Scholarship Granting Organizations) in Alabama - no charitable deduction can be claimed on federal tax return if the donor receives a dollar-for-dollar state tax credit
•6 states so far have enacted "PTE Taxes" (5 elective, one mandatory) in response and many more legislatures expected to consider this Spring
•Result: PTE not taxed at federal level (its owners are), but treated as a taxable C corp. for state income tax purposes; no SALT cap applies [we think] and donations to SGOs can be deductible as business expenses while company receives state tax credit
•Feedback so far? Favorable as long as taxpayer election and they can elect-out in 2-5 years if circumstances change.