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In this installment of A Pinch of SALT, the authors analyze the IRC's disparate capitalization requirements for domestic and foreign research and experimental expenditures for tax years beginning in 2022.

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Sometimes states intentionally favor domestic commerce, and sometimes they unintentionally discriminate against foreign commerce. In *Kraft*,[1] the U.S. Supreme Court made clear that both are illegal. Because most states' corporate income taxes conform to the IRC to some degree, recent federal tax changes set the stage for unintentional (and unconstitutional) discrimination.

This article analyzes the IRC's disparate capitalization requirements for domestic and foreign research and experimental expenditures for tax years beginning in 2022. While the federal government is free to treat foreign commerce differently from domestic commerce, states and localities do not enjoy that same freedom. Thus, when states conform to the IRC and incorporate the federal tax system's differing treatment of domestic and foreign R&E expenses, that conformity may violate the foreign commerce clause.

IRC Section 174 Overview and State Conformity

For administrative ease, states generally start with federal taxable income to determine taxable income. How states incorporate the IRC and its definition of federal taxable income typically falls into three categories: (i) states that adopt amendments to the IRC (rolling conformity); (ii) states that adopt the IRC as of a specific date (static or fixed conformity); or (iii) states that selectively adopt only specific IRC provisions to incorporate into their own taxability calculation (selective conformity).

[1] *Kraft General Foods Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992).

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The 2017 federal law known as the Tax Cuts and Jobs Act included numerous changes to federal taxable income — and the conformity to those changes has led to several interesting state tax consequences.[2] One TCJA amendment was the sunsetting of immediate expensing of R&E expenditures,[3] which did not become effective until 2022. Before the change, IRC section 174 allowed R&E expenses to either be immediately deductible in the year incurred or — at the taxpayer's election — capitalized and amortized over a period of not less than five years. Under the TCJA, for tax years beginning after December 31, 2021, taxpayers must capitalize and amortize domestic R&E expenditures over a five-year period.[4] R&E expenditures attributable to research conducted outside the United States, Puerto Rico, or any possession of the United States must be capitalized and amortized over a longer 15-year period.[5] Most taxpayers prefer a faster amortization period and thus benefit by engaging in R&E activities in the United States.

States with rolling conformity or static conformity with a conformity date after the enactment of the TCJA have incorporated the TCJA's five-year and 15-year treatment of domestic and foreign R&E expenses. While there is no constitutional problem with federal tax differences between domestic and foreign commerce, states disadvantaging foreign R&E expenses through a longer amortization period may have created a foreign commerce clause problem.

Foreign Commerce Clause History

The dormant commerce clause restricts states' power to tax interstate and foreign commerce.[6] It also requires that state taxes satisfy a four-prong test mandated by the Supreme Court in *Complete Auto*, under which a state tax will survive dormant commerce clause scrutiny only if it:

1. applies to an activity with a substantial nexus to the taxing state;
2. is fairly apportioned;
3. does not discriminate against interstate (or foreign) commerce; and
4. is fairly related to the services provided by the state.[7]

"In contrast to the deference that the Court has accorded the states when confronted with allegations that a tax lacks sufficient nexus with or is unfairly apportioned to the taxing state, the Court has scrutinized claims that a tax discriminates against interstate commerce with considerable vigilance."[8]

The foreign commerce clause places even greater restrictions on state taxing authority. The Court provided two additional prongs that a state tax must satisfy when applied to foreign commerce: (1) whether the state tax creates a substantial risk of international multiple taxation; and (2) whether it prevents the federal government from "speaking with one voice when regulating commercial relations with foreign governments."[9]

Kraft is a leading case that demonstrates the Court's limitation on state taxation of foreign commerce.[10] In *Kraft*, the Court struck down Iowa's corporate income tax on foreign dividends because it unconstitutionally discriminated against foreign commerce. This discrimination stemmed from Iowa's conformity to the federal income tax treatment of dividends, which allowed a deduction for dividends from domestic subsidiaries but not from foreign subsidiaries.

Iowa unsuccessfully argued that its treatment of dividends arose because of its IRC conformity, and that any discrimination was unintentional. Iowa defended its differential treatment of dividends because it was intended "to promote administrative convenience rather than economic

[2] *See, e.g.*, *Precision Castparts Corp. v. Nebraska Department of Revenue*, No. CI 22-2016 (Neb. Dist. Ct. June 30, 2023) (finding that the foreign-source income that was deemed repatriated under the one-time repatriation transition tax on previously untaxed foreign-source income did not meet the definition of dividend and was thus not entitled to the dividend received deduction); *Appeal of Microsoft Corp.*, OTA No. 21037336 (Cal. Tax App. July 27, 2023) (allowing Microsoft to include 100 percent of its foreign dividend income in its sales factor denominator).

[3] P.L. 115-97, 131 Stat. 2054, Title I, section 13206(a) (2017).

[4] IRC section 174(a)(2)(B).

[5] *Id.*

[6] *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979).

[7] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[8] Jerome Hellerstein, Walter Hellerstein, and Andrew Appleby, *State Taxation* 4.14 (3d ed. 2001 & Supp. 2021-2022).

[9] *Japan Line*, 441 U.S. at 451.

[10] *Kraft*, 505 U.S. 71 (1992).

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protectionism."[11] In rejecting this "no intention to discriminate" argument, the Court explained that "absent a compelling justification . . . a State may not advance its legitimate goals by means that facially discriminate against foreign commerce."[12] Moreover, the Court reasoned that a state "need not adopt the federal definition of taxable income" and that the administrative convenience afforded by IRC conformity "cannot shield a state statute from Commerce Clause scrutiny."[13]

Constitutional Issues With State Conformity to IRC Section 174

The constitutional questions that arise from state conformity to IRC section 174 are similar to those addressed in *Kraft*: whether conforming to the IRC's differential treatment of domestic and foreign R&E expenses violates the foreign commerce clause.

According to the *Kraft* Court, IRC conformity "cannot shield a state statute from commerce clause scrutiny" because a state is not required to "adopt the federal definition of taxable income."[14] *Kraft* stated that "Iowa could enjoy substantially the same administrative benefits by utilizing the federal definition of taxable income, while making adjustments that avoid the discriminatory treatment of foreign subsidiary dividends. Many other states have adopted this approach."[15]

The differential treatment of domestic and foreign R&E creates disparate treatment. However, states may defend discriminatory taxation if they can show that the tax "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives."[16] It is unlikely a state could satisfy this defense, especially considering that the following six states have adopted nondiscriminatory alternatives to IRC section 174 conformity[17]:

- Georgia: For tax years beginning on or after January 1, 2022, Georgia decoupled from the current IRC section 174, reverting to the version of IRC section 174 as it existed before the TCJA.[18]
- Indiana: For tax years beginning after December 31, 2021, Indiana decoupled from IRC section 174 by effectively requiring taxpayers to treat R&E expenses as they did before the TCJA changes to IRC section 174.[19]
- Mississippi: For tax years beginning after December 31, 2022, taxpayers may elect to immediately deduct R&E expenses, or to capitalize and depreciate the expenditures as provided in IRC section 174 as effective on January 1, 2021.[20]
- New Jersey: For corporation business tax periods beginning on or after January 1, 2022, New Jersey allows taxpayers to fully deduct R&E expenditures that also gave rise to a state research and development credit the taxpayer claimed during the tax year.[21]
- Tennessee: For tax years beginning on or after January 1, 2022, Tennessee changed its conformity to IRC section 174 to the version as it existed on December 31, 2017 — before the TCJA's enactment.[22]
- Wisconsin: Rather than by statute, Wisconsin provided its guidance through a Department of Revenue publication, which provides that for R&E expenses deductible under IRC section 174, in tax years beginning on or after January 1, 2022,

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[11] *Id.* at 81.

[12] *Id.*

[13] *Id.* at 82.

[14] *Id.*

[15] *Id.* at 81.

[16] *Oregon Waste Systems Inc. v. Department of Environmental Quality*, 511 U.S. 93, 101 (1994) (internal quotation marks omitted).

[17] In addition to IRC section 174 conformity, several states provide for their own R&E deductions or credits, but those are outside the scope of this article.

[18] Ga. Code Ann. section 48-1-2(14) ("Section 174 of the Internal Revenue Code of 1986, as amended, shall be treated as they were in effect before the 2017 enactment of federal Public Law 115-97.").

[19] Ind. Code Ann. section 6-3-2-29. Ind. Code Ann. section 6-3-2-29(b) requires that taxpayers deduct from adjusted gross income the R&E expenditures capitalized under IRC section 174(a)(2)(A) and add to AGI the amount deducted under IRC section 174(a)(2)(B).

[20] Miss. Code Ann. section 27-7-17(1)(f)(ii)(1); Miss. Notice 80-23-003 (Oct. 20, 2023).

[21] N.J. Stat. Ann. section 54:10A-4(k)(11).

[22] Tenn. Code Ann. section 67-4-2006(a)(11).

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> taxpayers may (i) elect to deduct the expenses in the year paid, (ii) deduct the expenses ratably over five years, or (iii) treat the expenses as capital expenditures that may be amortized over the item's useful life, if that useful life is determinable.[23]

State courts are not strangers to commerce clause inquiries related to the differential treatment of in-state and out-of-state expenses. For example, in *R.J. Reynolds* the New York Appellate Division held that a New York City statute that provided an accelerated depreciation deduction for New York state property but disallowed the deduction for a taxpayer's out-of-state property "confer[red] preferential tax treatment upon local businesses" and thus "discriminat[ed] against out-of-State property holders."[24] According to the appellate division, the city statute was "facially discriminatory" because it had the "practical effect of discriminating against taxpayers doing business in New York City who have commercial property located outside of New York."[25] The appellate division concluded that the New York City law's unequal treatment "threaten[ed] to exert 'an inexorable hydraulic pressure on interstate businesses to ply their trade within [New York] rather than among the several States.'"[26]

An evaluation of states' IRC section 174 conformity may result in a conclusion similar to *R.J. Reynolds*. The six nonconforming states have demonstrated the availability of nondiscriminatory alternatives to conformity. Given the U.S. Supreme Court's rejection of state tax regimes that provide a preference to domestic activity, taxpayers should consider the possibility of a legal challenge and potential outcomes. ■

[23] Wis. Tax Bull. No. 220 (Jan. 2023).

[24] *R.J. Reynolds Tobacco Co. v. City of New York Department of Finance*, 237 A.D.2d 6, 7 (N.Y. App. Div. 1997).

[25] *Id.*

[26] *Id.* at 13.

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