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A. State Conformity to Federal Provisions in General

Generally, state income tax conformity to the federal income tax treatment of a transaction or item is more the rule rather than the exception. Some states define "state taxable income" as federal taxable income plus or minus certain additions or subtractions while other states may define certain terms, like income, deduction, etc. as being the same as defined in the IRC. The high level of state conformity is most clearly evidenced in the states' income tax forms, where state taxable income is often computed by beginning with federal taxable income which is then adjusted for various items, rather than making a separate calculation of state taxable income. States may approach federal conformity in one of several ways in order to begin this calculation. Some states adopt a "rolling" conformity date and, as such, automatically conform to the latest version of the IRC, while other states use a fixed or static IRC conformity date and calculate state taxable income as contemplated as of a certain date. Still other states may take a selective approach to federal conformity by adopting only certain provisions or certain provisions as of certain dates.

State conformity to federal law has its advantages and disadvantages to both the states and taxpayers.[1] In many instances, taxpayers and state administrative personnel can rely on federal interpretations of the rules when analyzing the state tax treatment that results from conforming to the federal treatment.[2] There remains, however, the issue of whether a state's conformity to the IRC includes conformity to the rules and regulations promulgated thereunder—including Revenue Rulings, Revenue Procedures, and other IRS pronouncements.[3] Some state conformity statutes specifically provide that the incorporation of the IRC includes the administrative decisions and regulations and judicial decisions issued thereunder. Others, however, are silent on the issue.

When addressing issues of federal conformity, there is a general methodology that applies across the states. The first step is to identify the type of conformity—i.e. rolling, static, or selective—the state employs. If it is static conformity, the next step is determine if the federal treatment you are relying upon is a result of recent legislation, and whether the state in question has adopted the recent change. If it is selective conformity, it must be determined if the state conforms to the particular code provision at issue. Having identified the type of conformity adopted by a particular state and whether the state includes the relevant provision, it is then necessary to determine what modifications to the federal base the state may require to

[1] Some of the advantages include uniformity, the simplicity of a "single" starting point, and reduction of compliance costs while the disadvantages often include the loss of policy-making power and control over state revenue for the states as well as the delays in legislative action when the states need to affirmative conform to new legislation.

[2] See, for example Commission v. Fagerberg, 59 Ariz. 29, 122 P.2d 212 (1942) (federal tax law is similar enough to state tax law to make federal decisions very persuasive in interpreting state statutes), and Innes v. McColgan, 47 Cal. App.2d 781, 118 P.2d 855 (Cal. Ct. App. 1941) (similarities in the definitions of "gross income" for federal and California tax law permit the use of federal court decisions in interpreting California law). But see Meanley v. McColgan, 49 Cal. App.2d 203, 121 P.2d 45 (Cal. Ct. App. 1942) (state is not bound by U.S. Supreme Court decisions interpreting the IRC even though the state statute was modeled after the federal provision).

[3] For example, California explained in FTB Notice 89-277 (May 10, 1989) that where the provisions of the California Corporation Tax Law are in substantial conformity with the IRC, the Franchise Tax Board ("FTB") will also generally follow treasury regulations and Internal Revenue Service procedures and rulings. These rulings and procedures, however, will not be binding on the FTB for California purposes, "if an authorized officer or employee of the Franchise Tax Board has publicly indicated in writing that the ruling or procedure will not be followed."

derive state taxable income. This is where states often "decouple" from the federal provision by requiring addition or subtraction modifications.[4] Which modifications are required by a specific state may be a result of state fiscal policies, the encouragement of economic development within that state, or social objectives. As a result, it is a state-by-state determination when determining if a state conforms to any given federal provision.

Outline:

Federal Conformity

- Where states conform to the IRC, either 1) the state tax calculation begins with federal taxable income as the starting point, or 2) the state will conform to the *definitions* contained in the IRC.
- Some state conformity issues will depend on which line of the federal return, Line 28 or Line 30 (*i.e.,* federal taxable income before NOL and special deductions or federal taxable income after NOL and special deductions).
- When discussing state tax decoupling from the IRC, clients should be made aware of these critical state conformity issues and the various methods by which the state conforms to the federal tax rules in the IRC.[5] These methods fall into three general categories:
    - "**Rolling**" conformity states automatically adopt provisions of the IRC as enacted (*i.e.*, on a continual basis). The rolling conformity approach is generally less burdensome for both the states and taxpayers as it provides the simplicity of a "single" starting point and a resultant reduction of compliance costs.
        - 21 states have rolling conformity—Alabama, Alaska, Colorado, Connecticut, Delaware, District of Columbia, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Rhode Island, Tennessee, and Utah
    - "**Fixed date**" conformity states follow the IRC as of a certain, fixed date. Deliberate legislative action is required to update the state income tax laws to conform to the IRC as of a specific date.
        - 21 states have fixed date conformity—Arizona, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, New Hampshire, North Carolina, Ohio[6], Oregon, South Carolina, Texas, Vermont, Virginia, West Virginia, and Wisconsin

[4] These modifications often require adjustments for such items as state income taxes paid, depreciation, dividends received and net operating losses. For example, states may require the addition of taxes paid to other states, but will also provide a subtraction for federal taxes paid. Other states may decouple from the federal bonus depreciation provisions by requiring the addition of the deduction.

[5] There are a variety of ways to define each method of conformity with the IRC and, as a result, some states may fit into more than one category. For instance, Michigan can be classified as a fixed conformity state because it has a set conformity date of January 1, 2008. On the other hand, it but could also be listed as rolling conformity state because a Michigan taxpayer can elect to file under the current IRC by following the current IRC on the return. Furthermore, in this listing, we have classified California is included as a "selective" conformity state because even though California uses fixed conformity for many purposes, it also does not conform to key provisions of the IRC (for example, depreciation, treatment of Subpart F income, and a host of others). Other state and local tax publishers' conformity classifications listings will often list California as a fixed date conformity state because of its January 1, 2005 conformity date.

[6] The phasing out Ohio income tax was a fixed date state.

    - "**Selective**" conformity states adopt only certain IRC provisions, certain provisions as of a specific date, or make certain material changes to key IRC provisions.
        - 5 states have selective conformity— Arkansas, California, Mississippi, New Jersey, and Pennsylvania
- Certain states do not impose corporate or personal income taxes at all and consequently, changes to the IRC have no impact on state income taxation.
    - 4 states do not impose corporate income taxes – Nevada, South Dakota (except for financial services companies), Washington and Wyoming.
    - 7 states do not impose personal income taxes – Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington and Wyoming.