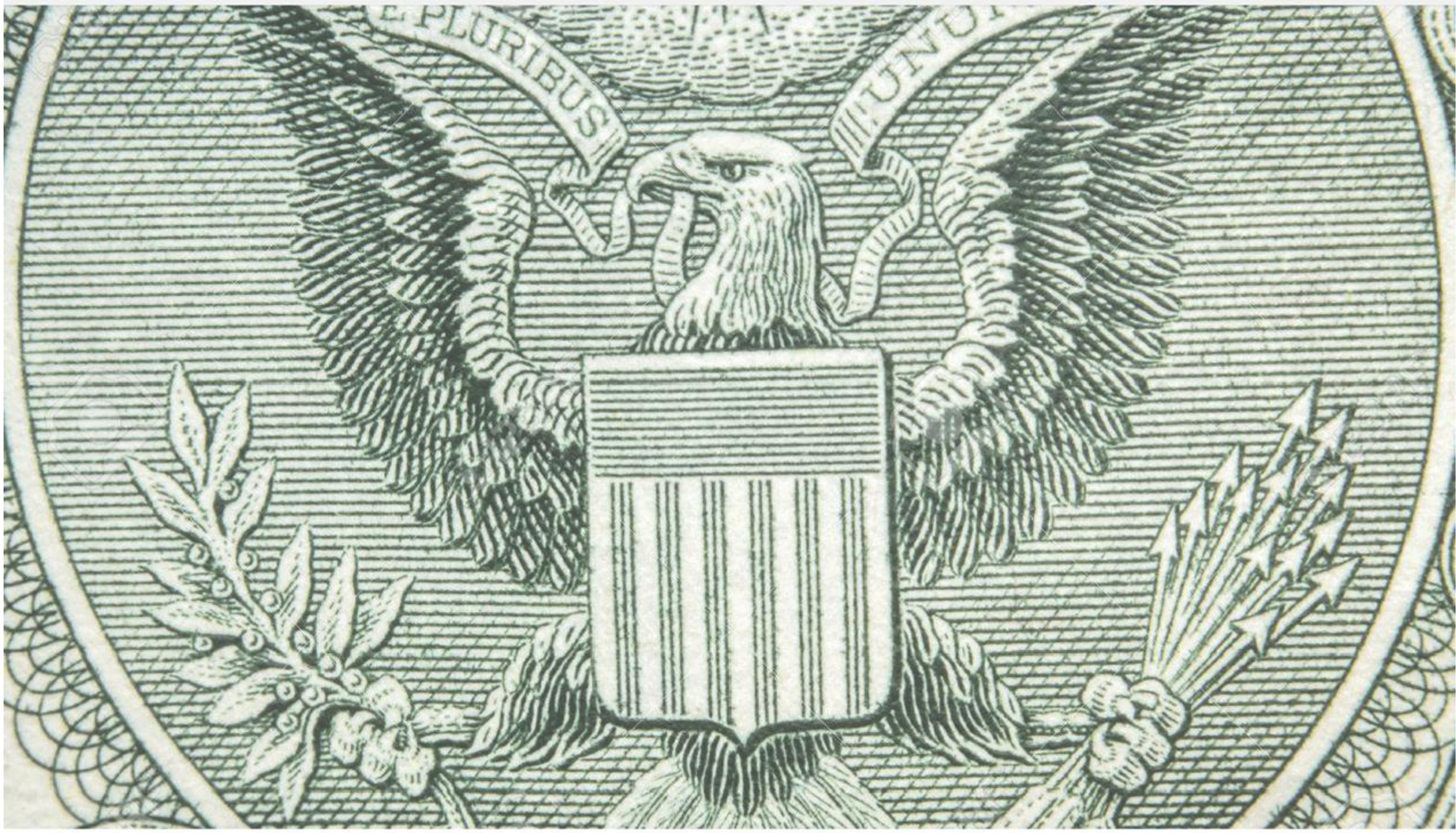
FISCAL BRIEF

2021 Tax Trends: Tax Cuts Back on the Menu



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Just last summer, states were looking down the barrel of a historic revenue drop as the spread of the coronavirus disrupted large parts of the economy and set off a recession. It seemed highly likely states would need to seriously consider a slate of potential revenue increases during 2021 legislative sessions. However, revenues began to perform better than expected and, in tandem with improving budget conditions, there was another round of federal funding for states in the form of the American Rescue Plan Act (ARPA). A new and improved revenue outlook led states to reconsider their priorities a bit. There were still tax increases here and there, but tax relief has been the primary focus of state legislatures in 2021.

Significant Income Tax Cuts

The most significant tax relief efforts have generally involved reductions in personal or corporate income tax rates. At least nine states passed measures to do so. Several other states, such as Arkansas, North Carolina, and Ohio are still considering income tax cuts and another three states, Mississippi, Missouri, and West Virginia, all had conversations about completely eliminating personal or corporate income taxes that ultimately fizzled out before the end of the session.

Cutting income taxes is a continuation of a long-standing trend that was put on hold last year. Coming out of the Great Recession, at least 14 states cut income tax rates and that trend continued well into the recovery, with six states cutting income taxes in both 2018 and 2019 as well. Income tax cuts in recent years have often been pared with offsetting sales tax base broadening efforts, but that has not been the case in 2021.

Arizona's legislature approved a significant personal income tax cut as part of the annual budget the governor is expected to sign. It consolidates the current four bracket structure into two brackets, with a 2.55% rate for income up to $27,272 for single filers and a 2.98% rate for income over that amount beginning in 2022. (The current marginal rate is 4.5% on income over $159,000. The current lowest rate is 2.59% on income over $26,000.) The rates will be reduced further to 2.53% and 2.75% in 2023, contingent on whether the state exceeds a specified General Fund revenue threshold.

Idaho approved a measure (H 380) that reduced the number of brackets, and provided an across the board cut, including a marginal rate cut from 6.925% to 6.5% retroactive to Jan. 1. It also provided a one-time tax rebate for 2020 personal income tax filers providing a minimum amount of $50 for each taxpayer and dependent or 9% of income taxes paid in 2019, whichever is greater. The rebate was estimated to cost $220 million and the tax cuts were estimated to cost about $163 million annually.

Iowa passed a tax package (SF 619) that, among other changes, accelerated planned income tax reductions by eliminating a revenue trigger and provided for a phaseout of the state inheritance tax. The cuts were estimated to lower revenues by $155 million in FY 2023 and the inheritance tax phaseddout would eventually cost $77 million by FY 2025.

Louisiana approved a measure (H 278) that implements an across-the-board income tax cut, including a marginal rate reduction from 6% to 4.25%, beginning in 2024. This depends on voters approving a companion constitutional ballot measure (H 274) that would eliminate the deductibility of federal income taxes paid, thus making the tax cut revenue neutral.

Montana passed a measure (S 159) to reduce its top income tax rate from 6.9% to 6.75%, which came with a revenue loss of $31.3 million in FY 2023 and $33.1 in FY 2024.

Nebraska also modestly reduced the marginal corporate income tax rate from 7.81% to 7.25% over two years.

New Hampshire
The state passed an appropriations measure that included cuts to the business profits tax (7.7% to 7.6%) and the business enterprise tax (0.675% to 0.55%), as well as a phaseout of the state's narrow income tax on interests and dividends by 2027.

Ohio
The governor is expected to sign a recently enacted budget bill that includes a substantial personal income tax rate reduction. The bill includes a 3% across the board cut for all brackets. It also eliminates the top bracket and sets the rate for the highest bracket at 3.99%, down from the old marginal rate of 4.797%. The income level at which the lowest tax bracket begins was also increased to $25,000 from $22,150. This provision was estimated to cost $915.8 million in FY 2022.

Oklahoma passed two separate tax cut bills (H 2960/H 2962). One cut the corporate income tax rate from 6% to 4% and another that reduced the individual income tax starting next year. The corporate income tax cuts were estimated to decrease tax collections for FY 22 by $53.9 million, and by $100 million in FY 23. The income tax cuts were estimated to cost another $83 million in FY 22 and $237 million in FY 23.

Other Tax Relief Enactments for Individuals
In addition to income tax rate reductions, there have been other, more targeted forms of tax relief. On the individual side of things, many states have provided for some kind of preferential tax treatment of Coronavirus Relief Payments as well as unemployment insurance benefits for a limited period. Arkansas, Alabama, Delaware, Maryland, Minnesota, and Mississippi have all passed legislation along these lines. Georgia provided a $140 million tax cut in the form of an increased standard deduction. Nebraska approved a phase-out of income taxes on social security income.

A handful of states also took action to increase the value of earned income tax credits (EITC) or child tax credits, or implement new ones, including Iowa, Indiana, Maryland and New Mexico. Other states established notable variations in their approach to assisting low-income taxpayers. Washington, a state without an income tax, created a new sales tax remittance program using federal EITC eligibility. The maximum $1,200 remittance would go to individuals with three or more children and that is reduced on a per child basis down to a maximum of remittance of $300 if the individual has no children. This credit program was estimated to cost $242 million in the FY 21-23 biennium. California also enacted a "Golden State Stimulus" program, which provides a $600 payment per tax return for recipients of the state earned income tax credit.

Several states, including Arkansas, Florida and Tennessee, created new sales tax holidays. This involves placing a temporary suspension on sales taxes for certain purchases, such as food or clothing.

A handful of states also took action to provide property tax relief. Utah increased the value of its circuit breaker credit. An approved measure in Colorado reduced property tax assessment rates for residential property, agricultural property and property used for renewable energy production. It also expanded the state property tax deferral program and was estimated to reduce local revenues by about $200 million per year.

Other Business Tax Relief Enactments

- **PPP Loans**

Relief for businesses, particularly small businesses, was a priority in many states. One prominent issue has been whether states will conform to the tax treatment of the Paycheck Protection loan program that was included in the CARES Act. The federal government determined the loans were not taxable and also that expenses funded by the loans are deductible. Allowing the double tax benefit is costly for states. Nationwide, roughly $500 billion in PPP loans would translate to billions in deductible expenses that would otherwise be taxable. But states are generally conforming to the federal treatment and at least 11 states have passed legislation to do so and quite a few others are still considering it.

- **SALT Cap Workarounds**

There has also been a recent rise in new entity-level taxes for S-corporations ever since the federal government capped the deduction for state and local income, sales and property taxes as part of the Tax Cuts and Jobs Act at the end of 2017. At the start of this year seven states (Connecticut, Louisiana, Maryland, New Jersey, Rhode Island, Oklahoma, and Wisconsin) had adopted entity-level taxes, which ARE fully deductible at the federal level, and created offsetting income tax credits as a way to provide relief to businesses. At least eight additional states have enacted SALT cap workarounds this year, including Alabama, Arkansas, Colorado, Georgia, Illinois, New York, North Carolina and South Carolina. For the most part, businesses are able to elect whether they want to be taxed in this manner; Connecticut is the only state that has made it mandatory.

- **Tax Credits/Exemptions**

Several states have taken expanded the use of business tax credit programs. New Jersey approved a notable $14.4 billion dollar incentive package to encourage businesses to stay in or move to the state. At least nine states have considered expanding film tax incentive programs and a handful have passed legislation to do so.

ARPA Tax Cut Restriction

These state tax relief efforts have moved forward despite some barriers put in place by the federal government. ARPA funds for states came with strings attached, including a clawback provision that restricts states' ability to use federal funds to offset reductions in tax revenue caused by changes in law, regulation or interpretation. That law, and subsequent rules issued by the Treasury, says that at any point between the ARPA enactment date and the end of 2024, a state that takes action to reduce net revenues by more than 1% against a baseline (i.e., FY 2019 "tax revenue indexed for inflation in each year of the covered period."), needs to be able to specify how that revenue loss will be offset, either through spending cuts, tax increases, or economic growth. Otherwise, they could be required to repay funds to the federal government. Subsequent guidance has clarified that this provision does not extend to actions that conform to federal tax laws but there's still some uncertainty about exactly what would trigger a clawback.

Based on the strong revenue growth states are experiencing, it is likely that most states will see net revenues above the baseline of FY 2019 revenues and will not need to worry about the clawback provision in the near-term. However, it is possible that an unexpected economic downturn in the future could put tax cutting states in a more vulnerable position.