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State Implications of Federal Tax Reform

National Conference of State Legislatures

State Taxation Task Force

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Notices

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Overview

Connection between federal and state taxes

Why does federal reform affect state corporate income taxes?

- Almost all states start the computation of state corporate taxable income with federal taxable income
  - Generally, either Line 28 or Line 30, subject to state-specific modifications
    - Common decoupling modifications include bonus depreciation, IRC section 199 deduction
  - Thus, federal changes that affect the computation of federal taxable income (or Adjusted Gross Income on the personal income tax side) would affect state taxes if the state adopts the change
  - Most changes in tax credits would not affect states; States typically adopt their own state-specific incentives
    - States sometimes allow a counterpart credit based on the federal credit, e.g., research and development or child and dependent care (personal)
  - Conformity to IRC generally serves interests of both state tax administration and taxpayer compliance

When would federal tax reform not affect state taxes?

- Keep in mind that certain states impose gross-receipts taxes in lieu of corporate income taxes (NV, OH, WA)

Conformity considerations

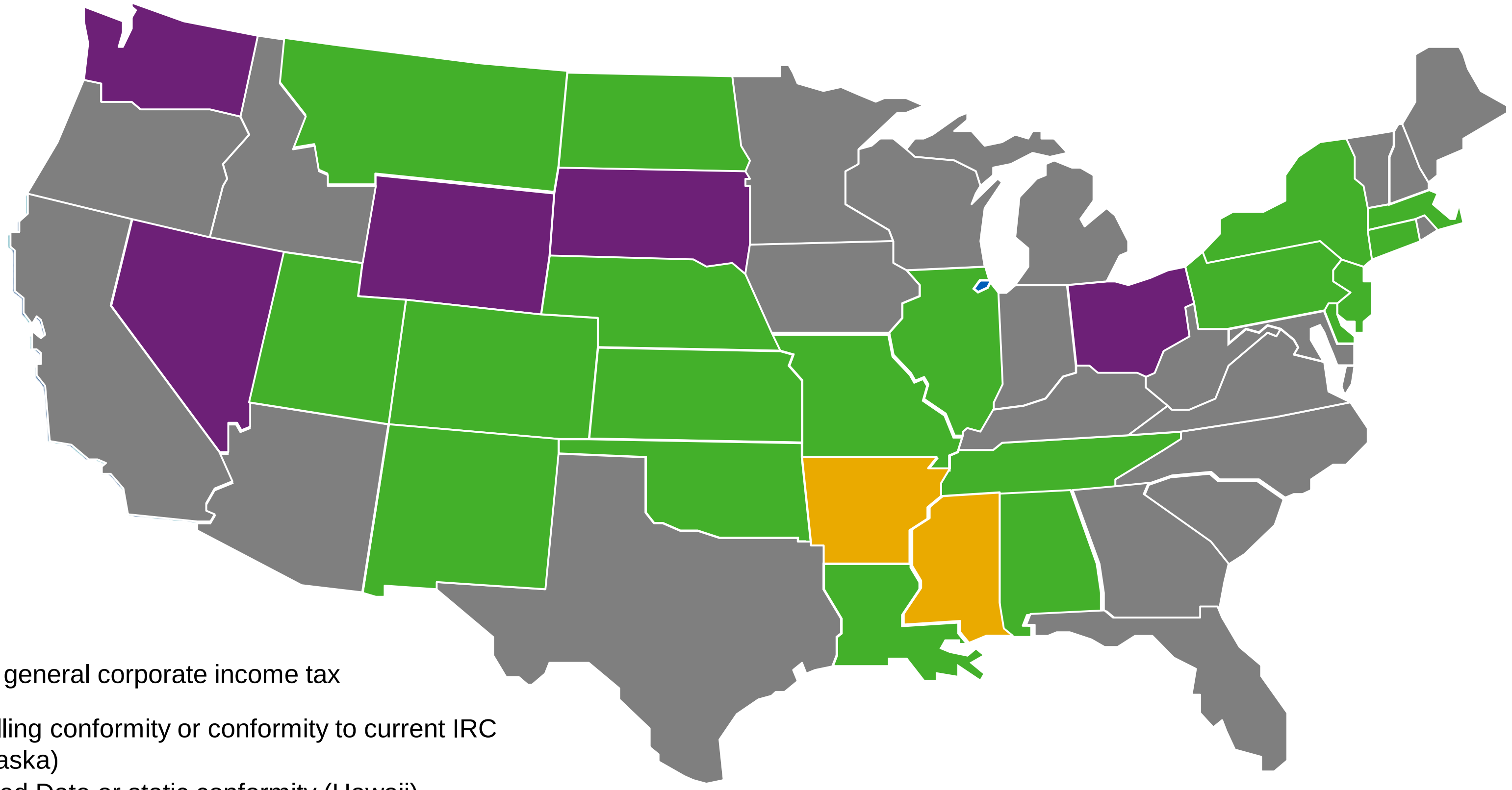
How do states conform to the Internal Revenue Code?

- “Moving” or “rolling” conformity states- these states adopt the IRC as currently in effect for the tax year in question
  - All federal changes will be automatically incorporated into the state’s law unless a specific decoupling modification is enacted

- “Fixed-date” or “static” conformity states- these states conform to IRC as of a certain date
  - For example, if a state conforms to the IRC as of January 1, 2014, the state does not adopt any federal tax changes that occurred after that date that would go into the computation of “federal taxable income” or other features to which the state conforms
  - Most fixed-date states (notable exception is California) update their conformity regularly during the state’s legislative session

At individual level, most states begin with AGI and conform to itemized deduction definitions; establish their own personal exemption allowances and standard deduction

State IRC conformity



No general corporate income tax

Rolling conformity or conformity to current IRC (Alaska)

Fixed Date or static conformity (Hawaii)

State conforms only to specific sections of the code

Source: Federation of Tax Administrators

Why conform

Conformity generally serves purposes of both taxpayers and state tax administrators

- For taxpayers is primarily an issue of simplicity, ease of compliance and availability of information
  - Consistent tax base
  - Deviations from base based on known amounts (e.g., exclude select items in federal base
  - Single set of definitions, guidance, etc. as to major features
- For tax administrators/states is primarily an issue of simplification as well as compliance and enforcement
  - Can rely on federal definitions, guidance, etc.
  - Information and simplicity improve the ability of taxpayers to comply and “get it right”
  - Rely on or benefit from IRS for information reporting and compliance efforts
- Consequences of non-conformity are increased complexity and potentially decreased compliance

Key State Tax and Fiscal Impacts

Marquee items for states

Business Tax Reform

- 20% corporate rate – no direct effect
- Reduced pass-through rate
  - Deduction approach of Senate is an issue for states
- Expensing – Would not expect substantial changes in conformity
- Limitation on interest expense deduction – coordinate with addback
- NOLs – substantial nonconformity now
- Other deductions – modest broadening
- Contribution to capital rules

International Tax Reform

- Shift to a territorial system
- Repatriation of deferred earnings as transition to territorial – substantial current exclusion of Subpart F
- Base erosion matters
  - Minimum tax – unclear impact
  - Interest disallowance – coordination with other limits
  - Excise tax – limited

Individual tax reform

House Ways and Means

- Reduce 7 rates to 4 and retain top rate of 39.6%
- Double standard deduction; repeal personal exemption allowances
- Expand child credit; add new family credit
- Eliminate most itemized deductions including state and local taxes except property tax – capped at $10,000
- Modify home mortgage interest; retain charitable deduction
- Repeal certain credits; modify education provisions
- Eliminate estate tax

Senate Chairman’s Mark

- Retain 7 rates with top rate of 38.5%
- Double standard deduction; repeal personal exemption allowances
- Expand child credit
- Eliminate most itemized deductions including for all state and local taxes
- Retain mortgage interest and charitable deduction unchanged
- Double estate tax exemption

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Overall assessment - structural

- From a structural standpoint, there may be less here than meets the eye; issues will be complex but (mostly) of modest impact
  - Coordinating interest disallowance with addbacks
  - Determining amount of repatriation and foreign inclusion and then resolving sourcing issues
  - Determining conformity to international base erosion provisions and if changes are necessary/desirable
- Greatest structural impact will be on individual side
  - Taxable income states because of proposal to double standard deduction and repeal personal exemption allowance – household size and distribution issues
  - Conformity on itemized deduction – no revenue impact from repeal of state and local income tax deduction

Overall assessment - fiscal

- As proposed, bill would reduce federal revenues by $1.5 trillion over 10 years – as provided for in the budget resolution.
  - Without dynamic scoring
  - Question on whether all base broadening can be made to hold

- To the extent tax cuts are deficit-financed, this imposes fiscal constraints on the federal government and its ability to finance intergovernmental programs
  - Stuff rolls down hill

- Certain aspects of reform may serve to constrain state tax resources
  - Repeal of deduction for state and local income taxes
    - Increases the after-tax costs of state and local government at a time when federal resources will be constrained
    - Reducing federal rates has similar effect
    - Somewhat of an incentive to favor property taxes, but many states have constitutional property tax limits

Timing is delicate and important

- Timing could be an issue- as it is not yet clear if federal tax reform will be enacted, when it might be enacted OR when it would be effective if enacted
  - Most state legislatures convene and adjourn within a few months during the first part of the year
    - Some states have very short sessions and federal tax reform may be enacted after the state legislature has adjourned
    - Depending on the effective date- states may have to convene a special session to address tax reform changes or put off addressing until the following year
- If enacted in 2017 with a 2018 effective date, time for state analysis and changes is short in many cases.
- States may take some precautionary/protective steps in 2018 legislative sessions

What to expect from states?

- Prospects for state reductions in rates is unclear (at best)
  - Any state base broadening likely to be relatively less than at federal level because of lack of conformity and other issues
  - State fiscal conditions may not allow for it, and deficit financing not allowed
    - Many states experiencing fiscal difficulties at the present time
    - Impact of reform is to further restrain resources and increase responsibilities
  - Limited pressure for state reductions in pass-through rates unless they also reduce regular corporate rate

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Thank you

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