FEDERAL TAX REFORM AND THE STATES

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Got conformity?

- Corporate and individual income taxes come in all shapes and sizes—conformity does as well

- VERY simple look at tax calculation:

\[
\text{Income tax base} \\
+/- \\
\text{Adjustments (exemptions, costs, etc)} \\
= \\
\text{Taxable Income} \\
\times \\
\text{Tax Rate} \\
= \\
\text{Tax Liability before credits}
\]
Where does the link come in?

- Many states use federal definitions for their base:
  - Individual Federal AGI: 29 including DC
  - Federal Taxable income: 8
  - "Independent": 4
  - Corporate: most states couple to some federal items
- 32 States use most of federal itemized deductions
- 6 States allow deduction of federal taxes
- 26 States couple of the earned income tax credit (percent of the federal EITC)
- 46 states with a state corporate income tax are coupled to a federal base; depreciation rules often coupled
Recent federal changes and the states

• **TRA86**
  - Major federal reform with broader tax base and lower rates
  - Impact on states through income tax coupling
    - Reduced itemization thereby reducing the offset to state and local taxes
    - Sales taxes no longer deductible at all!
    - Issues of exemption of municipal debt
    - Base broadening windfall
    - Net effect—short term increase in state income tax revenues

• **Federal Estate and Gift tax repeal**
  - 2001 phase out (until 2011) effectively eliminated state estate tax for many states
  - Some states countered via new laws (or were not originally coupled)
  - Some states projected large losses (CA $2.7 billion, FL $1.9 billion)
Exhibit

• Itemized deduction for state income tax

  • Tax Expenditure (estimate):
    • $280 billion in state-local income tax deductions
    • $64 billion (loss of federal revenue)
    • “Reduces” the bite of federal income tax by $64 billion or $1,730 per taxpayer
    • Eliminating this itemized deduction would increase the net amount of tax paid by $1,730
Pew Center: % Filers deducting mortgage interest

Source: analysis of IRS Statistics of Income, Table 2: “Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2011.”
Need more?

- **Accelerated Cost Recovery and Bonus Depreciation**
  - Federal changes in the 1980s, 2000s
  - Increases the deduction for new equipment
  - Increased other depreciation allowances
    - Reduced tax base (corporate and individual)
  - States that couple saw a shrinkage in base unless they made provisions
  - Apparently little concern regarding state impacts
Why couple?

• Close coupling makes states vulnerable to expansions and contractions in federal law regarding: tax base, credits, exemptions, deductions, etc.

• PROS:
  • Reduce complexity
  • Reduced administrative burden for states
    • Information sharing can increase compliance
  • Less contentious state policy debate

• CONS:
  • Beholden to federal changes
  • Windfalls—plus and minus
  • Can you rebuke changes that the feds make?
Reform Proposals Generally - Individual

- Reduce/eliminate all or most preferences -- exemptions, deductions, exclusions and credits
  - Possible retention of the vital few
  - Convert to a credit to minimize distributional issues
  - Limit value to a specified rate

- Substantial reduction of tax rates and simplification of bracket structure

- Treatment of all income as "ordinary" income

- Use of standard deduction and exemptions for progressivity and eliminating large numbers of taxpayers
Reform Proposals Generally - Corporate

• Substantial reduction of tax rate
  • Reduce/eliminate many preferences -- deductions, credits, and accelerated depreciation methods

• Move to a "territorial" system
  • Tax income "earned" in the U.S.
  • Eliminate deferral of tax on foreign earnings

• Question of how to retreat prior foreign earnings on which tax has been deferred
  • What to do with the revenue
Bowles-Simpson Proposals

- Eliminate all preferences and reduce rates
- Reduce individual rates to 8/14/23%
- Reduce corporate rate to 26%
- Contributes $80 billion (rising to $180 billion over decade) to deficit reduction
Domenici-Rivlin Proposal

• **Individual Income Tax**
  • Eliminate most preferences; all income taxed as ordinary income
  • Convert home mortgage interest and charitable to refundable credit of 15%, i.e., reduction in tax of 15% of amount paid (limit on mortgages)
  • Restructure and simplify low-income provisions
  • Two rates -- 15% and 27%

• **Corporate Tax**
  • Eliminate most preferences -- single rate of 27%

• **VAT of 6.5% for deficit reduction**
What’s It Mean for States – Individual?

- Exclusions (health insurance, retirement contributions, etc.) will generally flow through and expand state base -- Affect computation of AGI

- Itemized deductions -- Changes will generally flow through to state
  - Including limit expressed as a "floor", e.g., expenses in excess of x% of AGI
  - Not so with limiting value or converting to credit

- Changes in credits -- Flow-through unlikely unless it is one states commonly couple to as with EITC and (less so) child and dependent care

- Standard deduction and exemption -- Flow-through only in taxable income states

- Rate reductions and simplifications -- No flow-through
What’s It Mean for States – Corporate?

• Changes affecting base generally flow-through -- elimination of preferences, changes in depreciation

• Territorial system -- Likely a modest impact
  • Repatriation provisions likely minimal because of dividends received deduction and requirements for parity
  • Foreign income rules

• Expense allocation -- Depending on federal rules could be modest positive impact
What Happens Then?

• Federal -- Expanded base, reduced rates, simplified rate structure, simplified tax, more progressivity (?), fewer taxpayers (?), substantial concern about lost preferences

• State -- Expanded base, no change in rates, standard deduction or exemption level (most states), pressure to retain particular preferences

• Choices for states
  • Do nothing -- revenues, complexity, compliance
  • Follow Federal -- Adopt policies as to treatment of income and expenses; distribution is independently controlled by states
  • Something in between -- Where to draw line; impact on complexity and compliance
Second-Order Issues

• State-Local Tax Deductibility
  • Repeal will increase the “after-tax cost” of state and local services
  • Degree of increase depends on final rate
  • Disruptive of fiscal federalism
  • Little discussion singling out state and local taxes

• State-Local Borrowing Costs
  • Similar effect if state-local bond interest is taxable
  • Reduction in attractiveness to high-income investors
  • Potential impact on borrowing costs and ability to finance projects
What If…?

• Federal government moves to consumption tax (VAT)
• Potential crowding out or competition for the consumption tax space
• Pressures to conform state-local taxes to the federal consumption tax
  • Reduce complexity and simplify administration
  • Potential improvements in structure and elasticity of state-local sales taxes
  • Potential ‘loss’ of policy control over the sales tax base
• Replacement of income tax would also create serious issues for states
  • Can states maintain a state income tax with no federal counterpart
Institutional Issues

- Little or no capacity for state revenue or tax impact analysis at the federal level
  - CBO is expenditure and preemption focused
  - Joint Committee on Taxation not involved
  - Same holds in the executive branch
- Congressional jurisdiction rules create difficulties
  - House Judiciary has jurisdiction over most state tax matters, but Ways and Means has jurisdiction over IRC
  - Consolidated on Senate side, but little interaction with Judiciary
- Little concern or acknowledgment of federal-state interconnectedness
  - Estate tax is “Exhibit A”
  - Issue of revenue for federal government
What To Do…?

• Understand relationships with your state tax structure
• Monitor reform proposals
• Build/maintain capacity for analysis of the impact of federal proposal at the state level
  • Magnitude
  • Distributional