Federal Tax Reform

NCSL Executive Committee Task Force on State and Local Taxation
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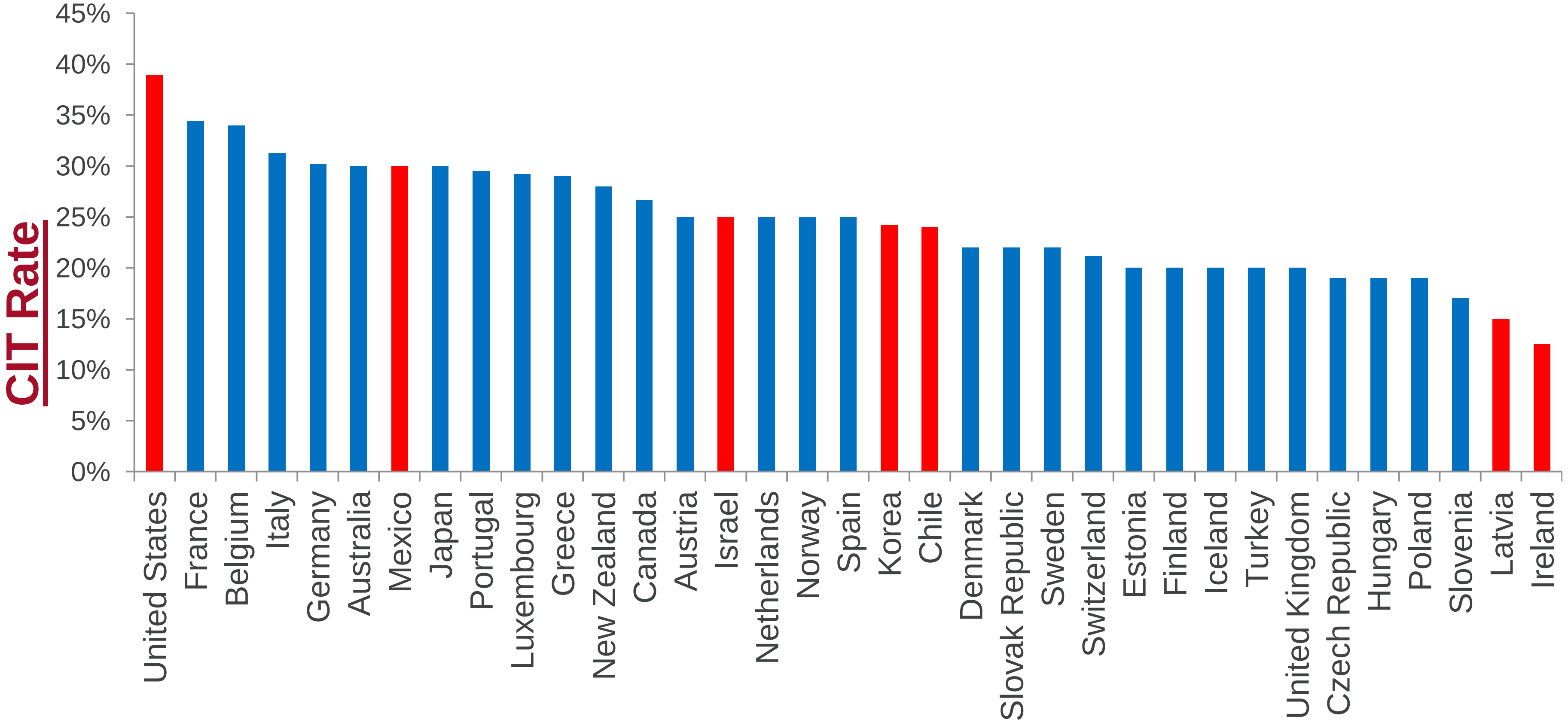
AGENDA

- The Shifting Economic and Political Landscape
- Key Elements of Federal Tax Reform Proposals
- Deeper Dive into State Tax Implications
- Next Steps

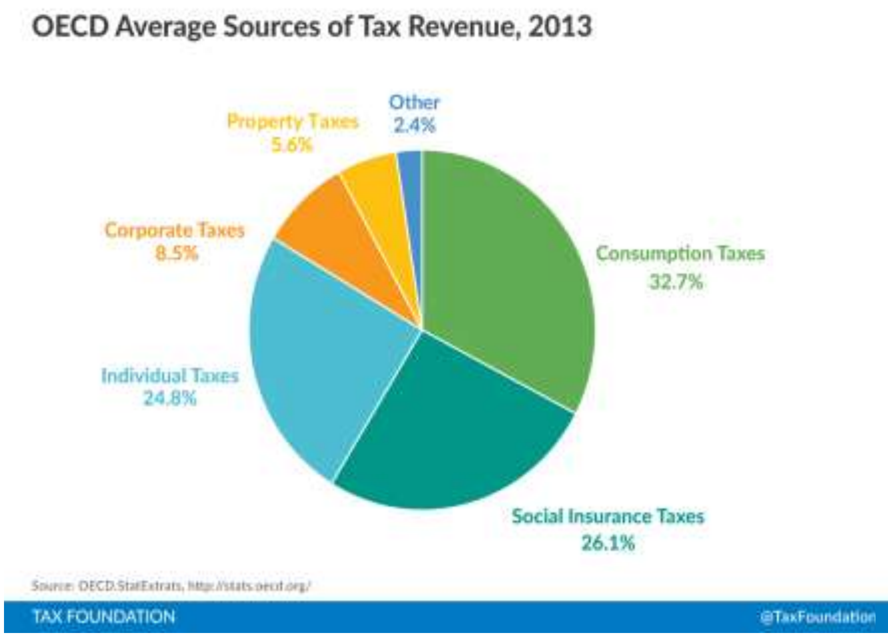
The Shifting Economic and Political Landscape

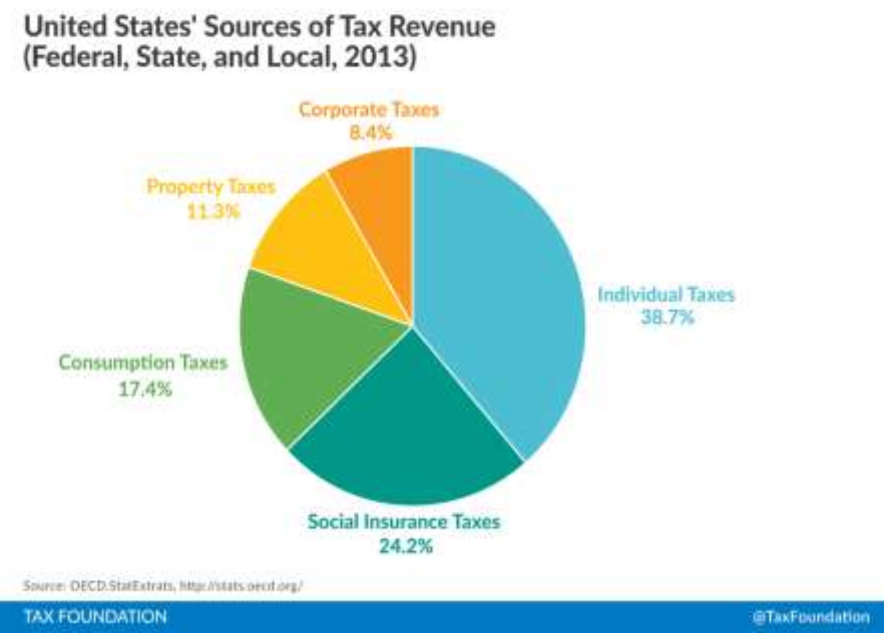
US Income Tax System Out of Step w/ Rest of the World

Worldwide Taxation
Territorial Taxation



The U.S. Relies Less on Border Adjusted Consumption Taxes: 33% OECD vs. 17% US



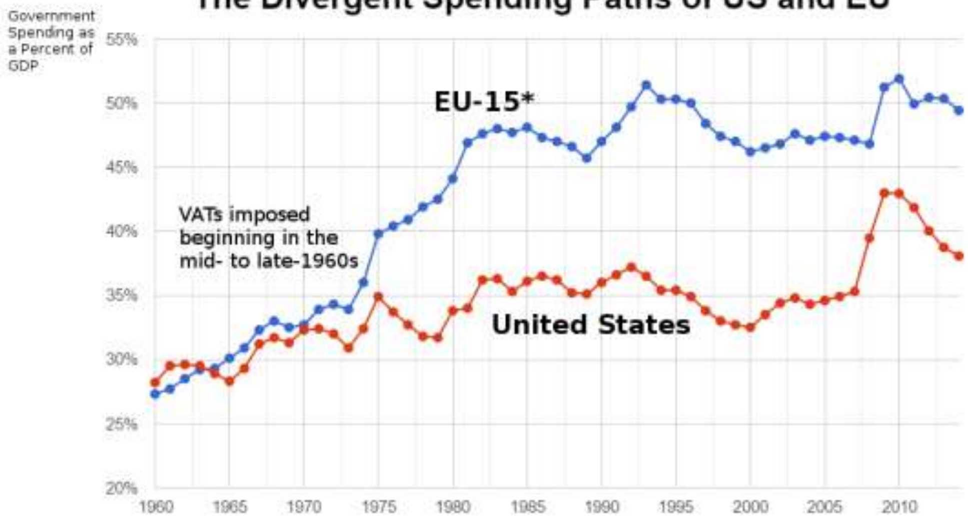


Republican Controlled Congress Does Not Want a VAT

- VATs in other countries have led to a huge growth in government spending.

Figure 1

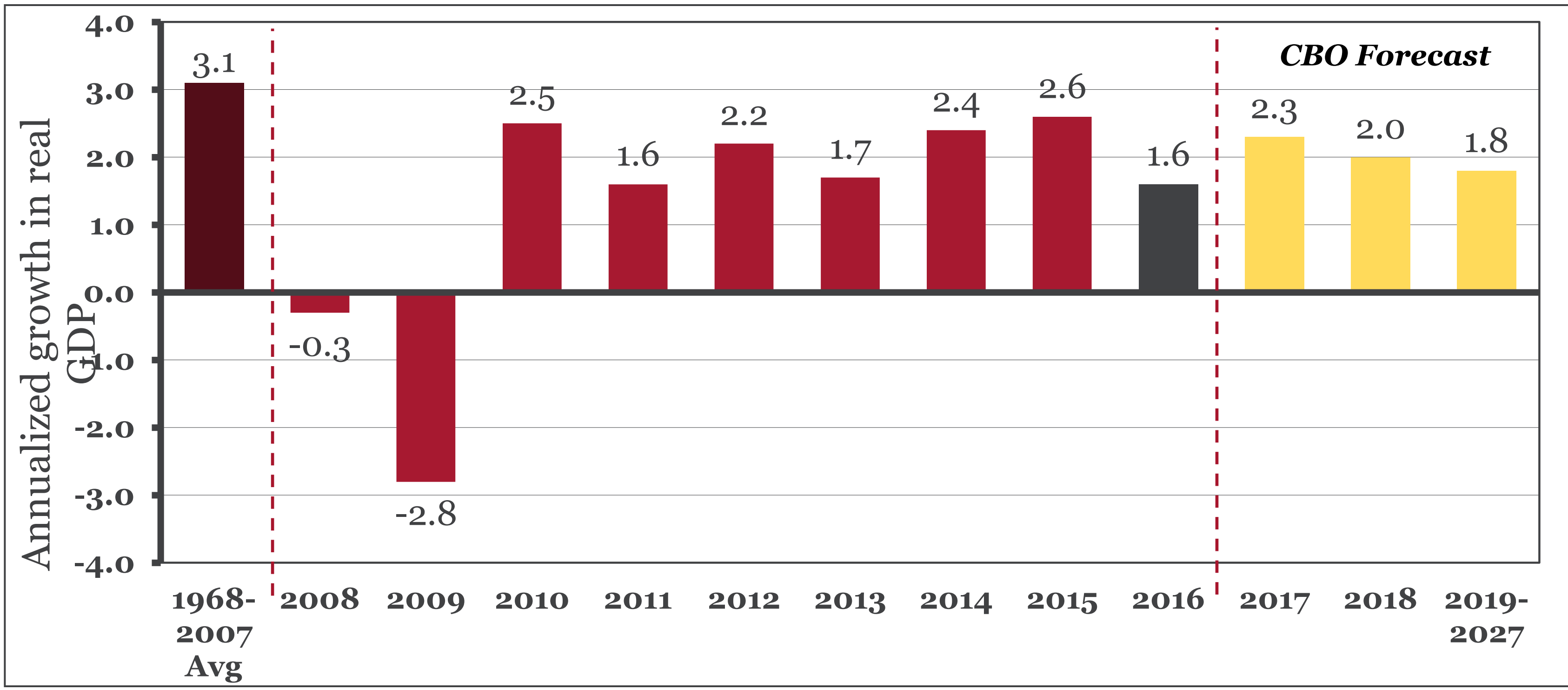
The Divergent Spending Paths of US and EU



*Does not include data for Luxembourg for 1988-1994, and Spain and Sweden for 1960-1969.

Sources: European Commission, European Central Bank, and OECD.

Downward Trend of U.S. Growth



Source: Bureau of Economic Analysis, January 2017.

Prospects for Sweeping Federal Tax Reform in 2017

Favorable Factors

- Comprehensive tax reform is a top priority of the Republican party that now controls the Presidency and Congress
- International tax pressures on the US
- Pressure for a legislative win

Potential Obstacles

- The divisions within the Republican party that are on display in the ACA repeal efforts
- Differences between the House Blueprint, President Trump's tax reform proposals, and Senate perspectives
- Different priorities within the U.S. business community
- State opposition to the elimination of the state and local tax deduction
- The complexity of enacting comprehensive federal tax reform

Key Elements of Federal Tax Reform Proposals

Comparison of House Blueprint and Trump Proposal

Provision	Current Law	House GOP 2016 Tax Reform 'Blueprint'	Trump April 26 Proposal
Corporate tax rate (federal)	35% rate	20% rate	15% rate
International tax regime	'Worldwide' system with deferral Foreign tax credits to mitigate double taxation	'Territorial' system 100% dividend exemption system	Territorial system
"Deemed" repatriation	n.a.	Previously untaxed foreign earnings: 8.75% tax rate for cash and cash-equivalents; 3.5% tax rate for non-cash assets.	Previously untaxed foreign earnings taxed at low rate (TBD)
Border Adjustment	n.a.	Border adjustment of corporate tax	Not included in proposal
Cost recovery (full expensing)	Recover over the investment's applicable life (50% bonus depreciation for equipment in 2017,)	Full expensing for depreciable and amortizable investments (tangible and intangible)	Not included in proposal
Business interest expense	Deductible as incurred	Deductible only against net interest income Special rules for financial services	Not included in proposal
Base Broadening	n.a.	Extensive base broadening by limiting PIT and CIT deductions and credits	Extensive base broadening by limiting many PIT and CIT deductions and credits
Top individual tax rate	39.6% plus 3.8% ACA tax, plus 1.2% phase out of itemized deductions	33% rate	35% rate
Pass-through businesses	Taxed at individual rates	Taxed at individual rates not to exceed 25%	15% rate

What Is the Senate Thinking? – Other Alternatives

- More traditional income tax reform (*differences from House and Trump in bold*)
  - Broader base and lower rates (like Reagan and Camp)
  - **Bonus depreciation with current law accelerated depreciation (instead of expensing)**
  - **No border adjustment**
  - **Maintain interest deduction or put some limitations on amount that can be deducted**
  - Pass through businesses – will get benefit of reform
  - Territorial
  - Deemed repatriation
  - Individual reforms - ???
- Simple rate cut

Federal Tax Reform: Impact on the States Based on Current IRC Linkage

Federal	States
▶ Reduce the top corporate income tax (CIT) rate	▶ States have own rates
▶ Broaden the CIT tax base	▶ State conformity
▶ Border adjustability	▶ State conformity
▶ Denial of interest deduction	▶ State conformity
▶ Expensing investments	▶ State partial conformity
▶ Reduced repatriation rate	▶ Modest impact
▶ Territorial tax regime	▶ Minimal conformity
▶ Reduce flow-through rate	▶ States have own rates
▶ Other personal income tax changes	▶ States have own rates, but generally conform to base broadening

Deeper Dive into State Tax Implications

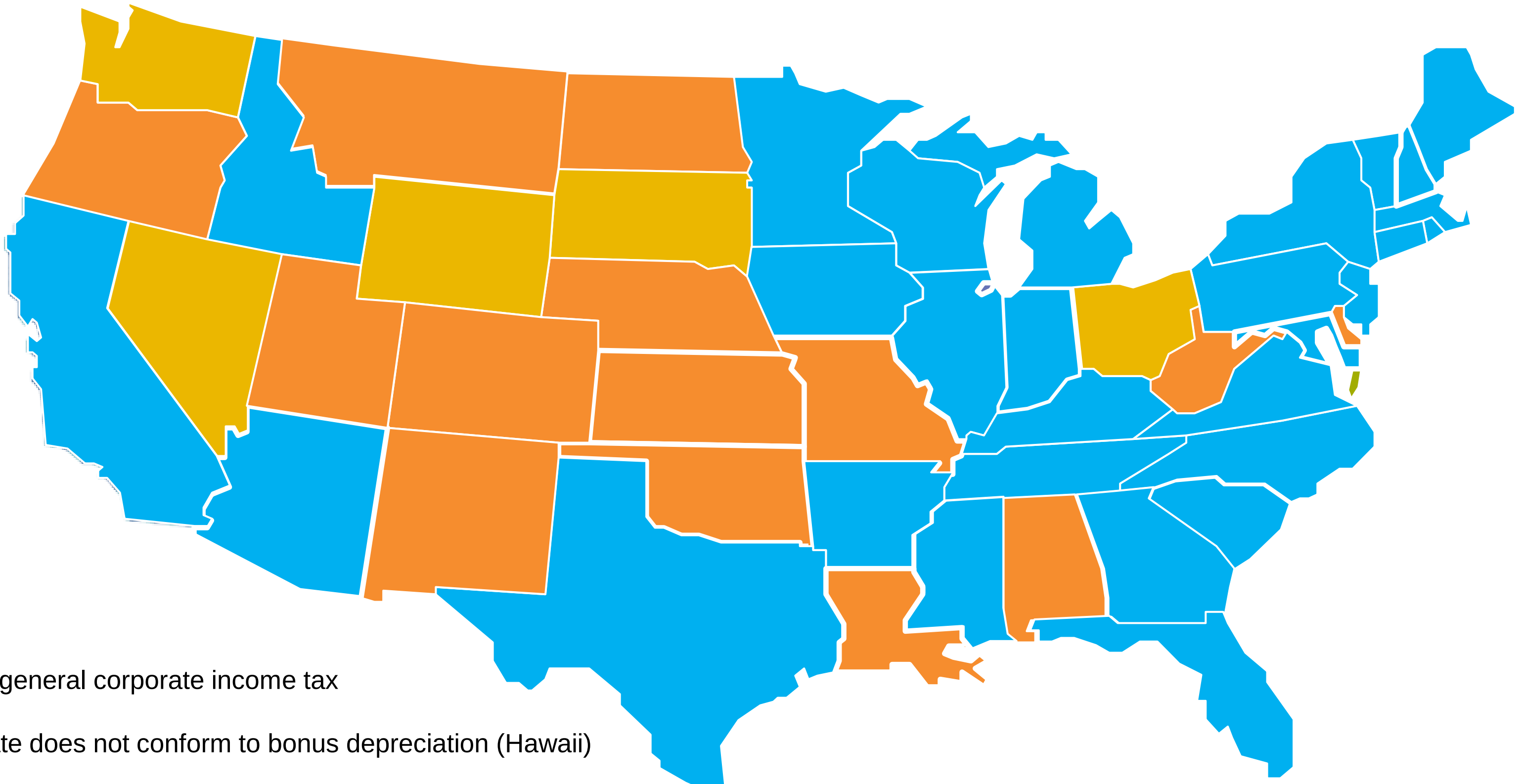
Corporate Income Tax Rate Changes

- Both the Trump proposal and the House Blueprint would dramatically reduce corporate income tax rates
  - Rates would drop to 15 percent under the Trump proposal and 20 percent under the House Blueprint
- No direct bearing on the states because they maintain their own corporate tax rates
- Will states experience a revenue decline in 2017 because taxpayers hold back on accruing income or generating gains in anticipation of lower federal tax rates.
- Would growth-oriented federal tax reform encourage states to lower their corporate tax rates or make other business friendly changes? Or would states move in the opposite direction to offset the federal impact?

Immediate Expensing of Assets: Cash Flow Taxation

- Allowing immediate expensing instead of depreciation over time is the key to the "cash flow" component of the House Blueprint
- Expensing is likely to be coupled with disallowing the deduction of net interest expenses
- In the past, states have widely decoupled from federal accelerated depreciation provisions.
- Continued non-conformity would require states to maintain their own capital cost recovery system
- In terms of changes to base, expensing would have the largest negative impact on federal tax revenues; the state impact would be comparatively greater because of current non-conformity on bonus depreciation

States decoupling from bonus depreciation



No general corporate income tax

State does not conform to bonus depreciation (Hawaii)

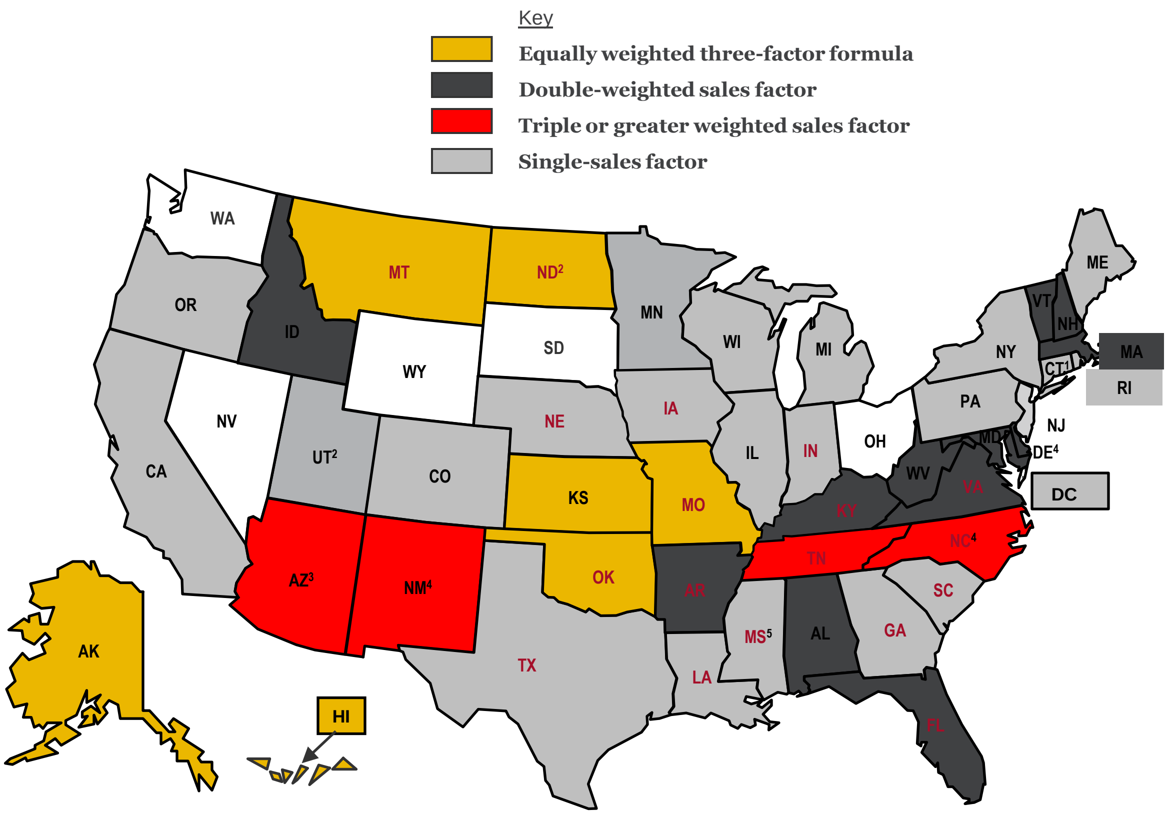
State conforms to bonus depreciation (Alaska)

Source: Thomson Reuters

Border Adjustability: Destination-Based Taxation

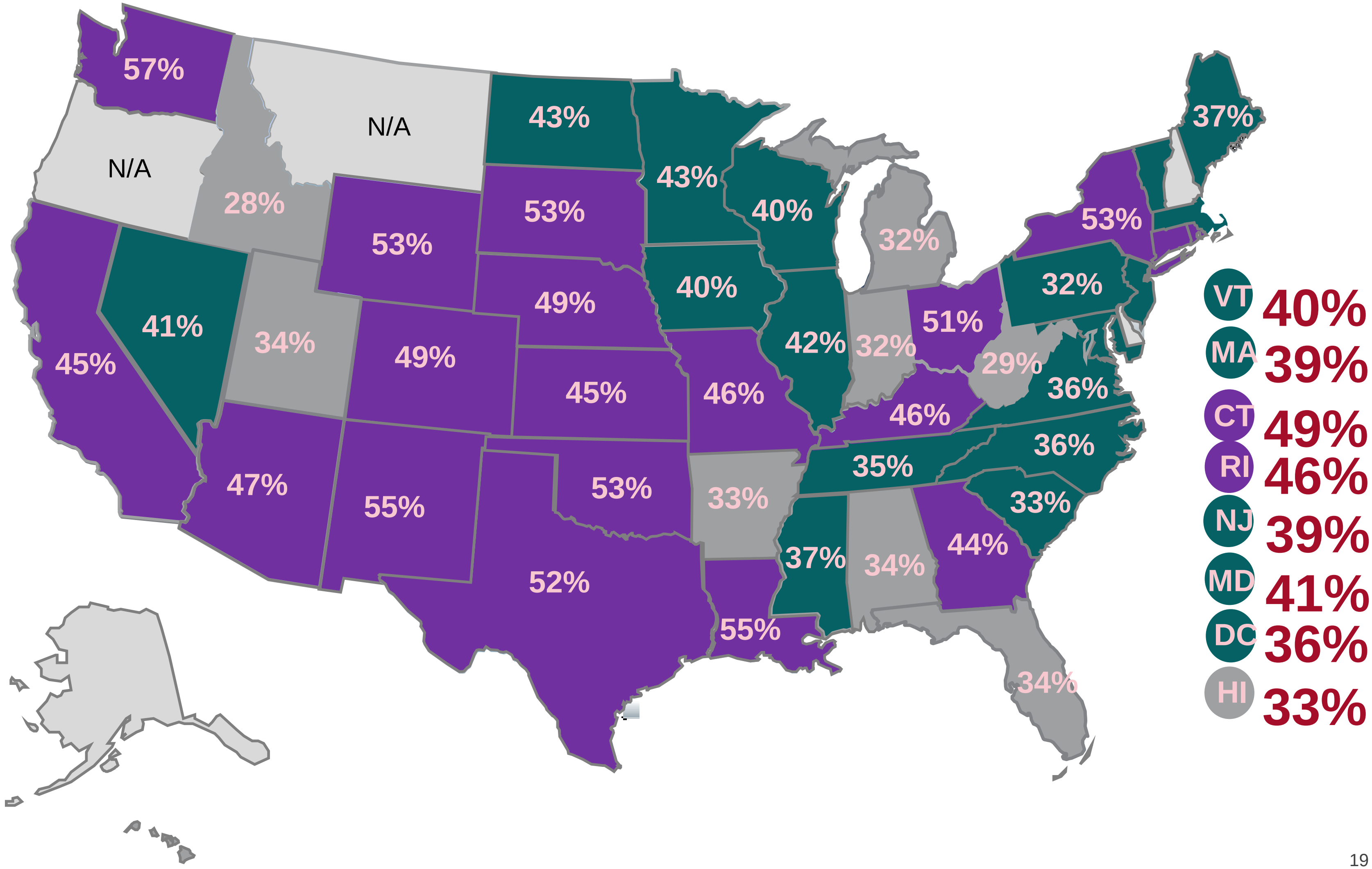
- Border adjustability is one of the most far-reaching and controversial provisions in the House Blueprint. It appears unlikely to be enacted in its current form.
- Essentially, the provision would favor exports over imports by excluding exports from taxable income and denying a COGS deduction for imports.
- There are many unanswered implementation issues.
- Estimated revenues of $1.2 trillion over 10 years. sufficient to fund 10 percentage point reduction in the CIT
- The BA would flow through to those states that conformed to the new tax base.
- **Even if the BA does not get enacted, will the debate over the importance of VAT-like border adjustments and expensing of investments have an impact on state-level income and consumption taxes?**

Border Adjustability: The Shift to Destination-Based State Corporate Income Taxes - 2017



State Sales Taxes: The Limited Recovery of Business Investments

Business Input Purchases Account for 42 percent of Sales Tax Base



Shift From a Worldwide to a Territorial Tax System

- The House Blueprint and Trump’s tax reform proposal would eliminate the current system of taxing U.S. companies on worldwide earnings (with deferral) and move to a territorial system where the tax is imposed on U.S.-sourced earnings
- States generally do not conform to the federal taxation of worldwide earnings.
- The impact on states would, of course, depend on their current treatment of foreign source income and foreign operations.
- An accompanying proposal for a reduced tax rate on repatriated foreign earnings might impact some states, depending on how the states are linked to the taxation of foreign dividends

Other Federal Income Tax Reform Provisions

- Establishing a lower tax rate for flow through entities under the personal income tax.
  - No direct impact on the states – but would some states enact similar rate reductions
  - Currently, at federal and state levels, C Corporations (with two levels of taxation) pay an effective tax rate that is 50 percent or more higher than that paid by flow through entities
- Allowing for a capital gains deduction
  - Few states currently allow for preferential treatment of capital gains and dividends
  - This provision is likely to be structured as a 50 percent deduction, so states will have to affirmatively opt out of the federal tax law change.

PIT Base Broadening Proposals: Indirect Impacts

- Repealing the itemized **deduction for state and local taxes** would increase the “after tax” cost of state and local services, particularly for taxpayers in states with high personal income tax rates.
    - Eliminating the deduction for state and local taxes accounts for about $1.8 trillion (over 10 years) of the $2.3 trillion base broadening from eliminating all PIT itemized deductions except for charitable and mortgage interest deductions.
- Repealing the **exclusion for state and local bond interest** would increase the cost of state and local government financing.
    - Eliminating the exclusion for state and local bond interest accounts for $.26 trillion (over 10 years) of the $2.3 trillion base.

Next Steps

Key Questions Related to Federal Tax Reform Legislation

- Will corporate and personal income tax reform be combined or separated?
- Revenue neutral or deficit financed?
- With or without border adjustability?
- Will there be state tax windfalls, as occurred with the Tax Reform Act of 1986?
- Differences in state conformity
- Potential industry-specific impact
- Effective date, transition rules and phase-ins?
- Other fiscal impacts on the states:
  - Elimination of the state and local tax deduction.
  - Elimination of exemption for municipal bond interest
  - Concurrent impact of Medicaid financing reductions

Questions?