Options for Conforming to Federal Tax Code Changes, and Revenue Implications

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BACKGROUND

- States incorporate provisions of the federal tax code into their own codes to varying degrees, so federal reform has important implications for state revenue
- Because base-broadening provisions of new law often flow through to states, while corresponding rate reductions do not, most—but not all!—states will experience a revenue increase
- Federal reform creates both an opportunity and an impetus for state tax reform, with states responding in a variety of ways (retain, return, reform)

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MAJOR REVENUE DRIVERS

- Higher standard deduction –
- Repeal of personal exemption +
- Smaller itemized deductions (& fewer itemizers) +
- Pass-through deduction –
- Repatriation and international income +
- Interest deductibility and NOL changes +
- Pass-through and corporate expensing –
- Modification of business tax credits +

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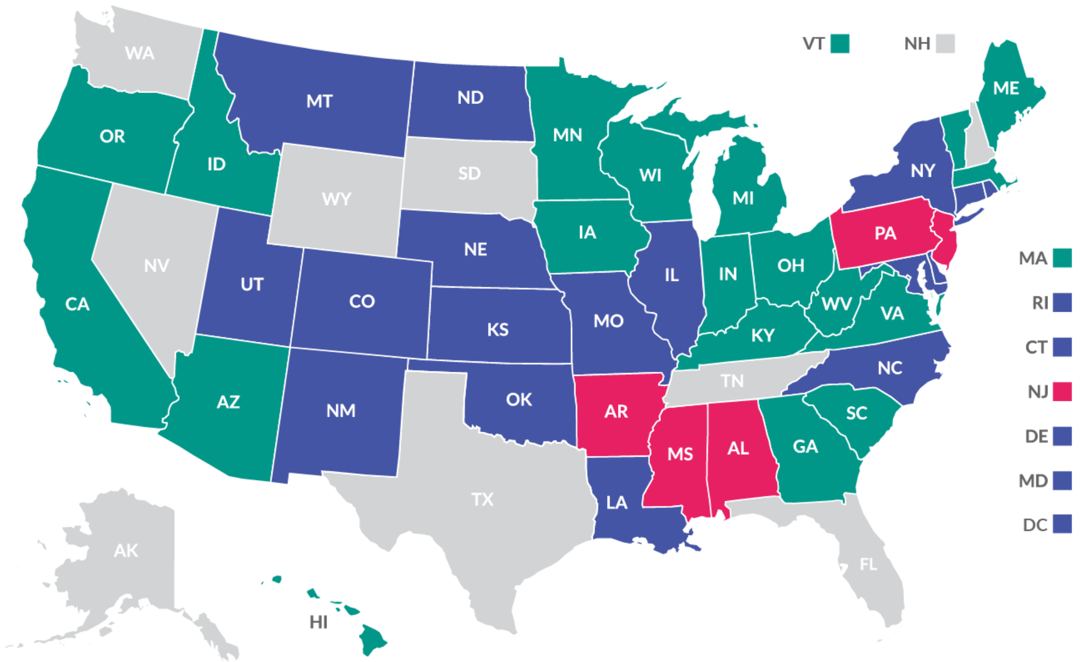
CONFORMITY METHOD

- Individual
  Rolling: 18 states + D.C.
  Static: 19 states
  Selective: 4
  No PIT: 9

- Corporate
  Rolling: 22 states + D.C.
  Static: 21 states
  Selective: 2
  No CIT: 5

Individual Income Tax Conformity



Note: States conform to the federal tax code on either a static or rolling basis. Static conformity means conforming to the Internal Revenue Code (IRC) as of a specific date, such as January 1, 2016. Rolling conformity means adopting IRC changes as they occur.
Source: State statutes; tax forms; Bloomberg Tax

Rolling Conformity
Static Conformity
No Conformity (State Calculation)
No Individual Income Tax

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FIVE SOURCES OF NEW REVENUE

- There are at least five broad categories of ways that federal tax reform will drive state revenue changes
- Only ***one*** of them requires states to conform to the latest (post-tax reform) version of the Internal Revenue Code—though it's an important one

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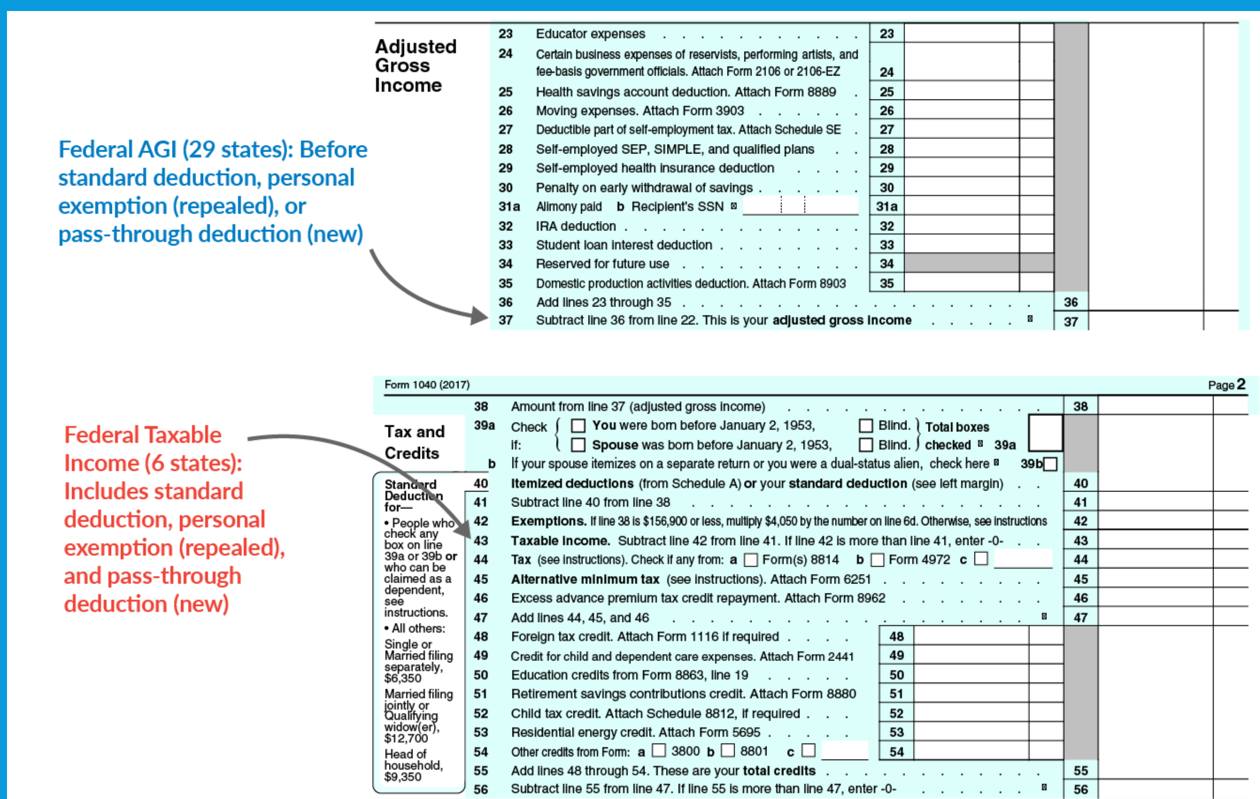
FIVE SOURCES OF NEW REVENUE

- Income starting point for state tax calculations
- Specific conformity provisions
- Filing uniformity requirements
- International income
- Dynamic economic effects

TAX CONFORMITY

FIVE SOURCES OF NEW REVENUE

- Income starting point for state tax calculations



Adjusted Gross Income

23	Educator expenses	23
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24
25	Health savings account deduction. Attach Form 8889	25
26	Moving expenses. Attach Form 3903	26
27	Deductible part of self-employment tax. Attach Schedule SE	27
28	Self-employed SEP, SIMPLE, and qualified plans	28
29	Self-employed health insurance deduction	29
30	Penalty on early withdrawal of savings	30
31a	Alimony paid b Recipient's SSN	31a
32	IRA deduction	32
33	Student loan interest deduction	33
34	Reserved for future use	34
35	Domestic production activities deduction. Attach Form 8903	35
36	Add lines 23 through 35	36
37	Subtract line 36 from line 22. This is your **adjusted gross income**	37

Form 1040 (2017) Page **2**

Tax and Credits

Standard Deduction for—
• People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions.
• All others:
Single or Married filing separately, $6,350
Married filing jointly or Qualifying widow(er), $12,700
Head of household, $9,350

38	Amount from line 37 (adjusted gross income)	38
39a	Check if: **You** were born before January 2, 1953, Blind. **Spouse** was born before January 2, 1953, Blind. **Total boxes checked**	39a
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here	39b
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40
41	Subtract line 40 from line 38	41
42	**Exemptions.** If line 38 is $156,900 or less, multiply $4,050 by the number on line 6d. Otherwise, see instructions	42
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43
44	**Tax** (see instructions). Check if any from: a Form(s) 8814 b Form 4972 c	44
45	**Alternative minimum tax** (see instructions). Attach Form 6251	45
46	Excess advance premium tax credit repayment. Attach Form 8962	46
47	Add lines 44, 45, and 46	47
48	Foreign tax credit. Attach Form 1116 if required	48
49	Credit for child and dependent care expenses. Attach Form 2441	49
50	Education credits from Form 8863, line 19	50
51	Retirement savings contributions credit. Attach Form 8880	51
52	Child tax credit. Attach Schedule 8812, if required	52
53	Residential energy credit. Attach Form 5695	53
54	Other credits from Form: a 3800 b 8801 c	54
55	Add lines 48 through 54. These are your **total credits**	55
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56

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FIVE SOURCES OF NEW REVENUE

- Specific conformity provisions
  - Standard deduction
  - Personal exemption
  - Itemized deductions
    Mortgage interest, moving expenses, medical expenses, property taxes, etc.
  - Cost recovery
  - Net operating loss provisions
  - Interest deductibility
  - Manufacturing expenses
  - Estate tax exemption

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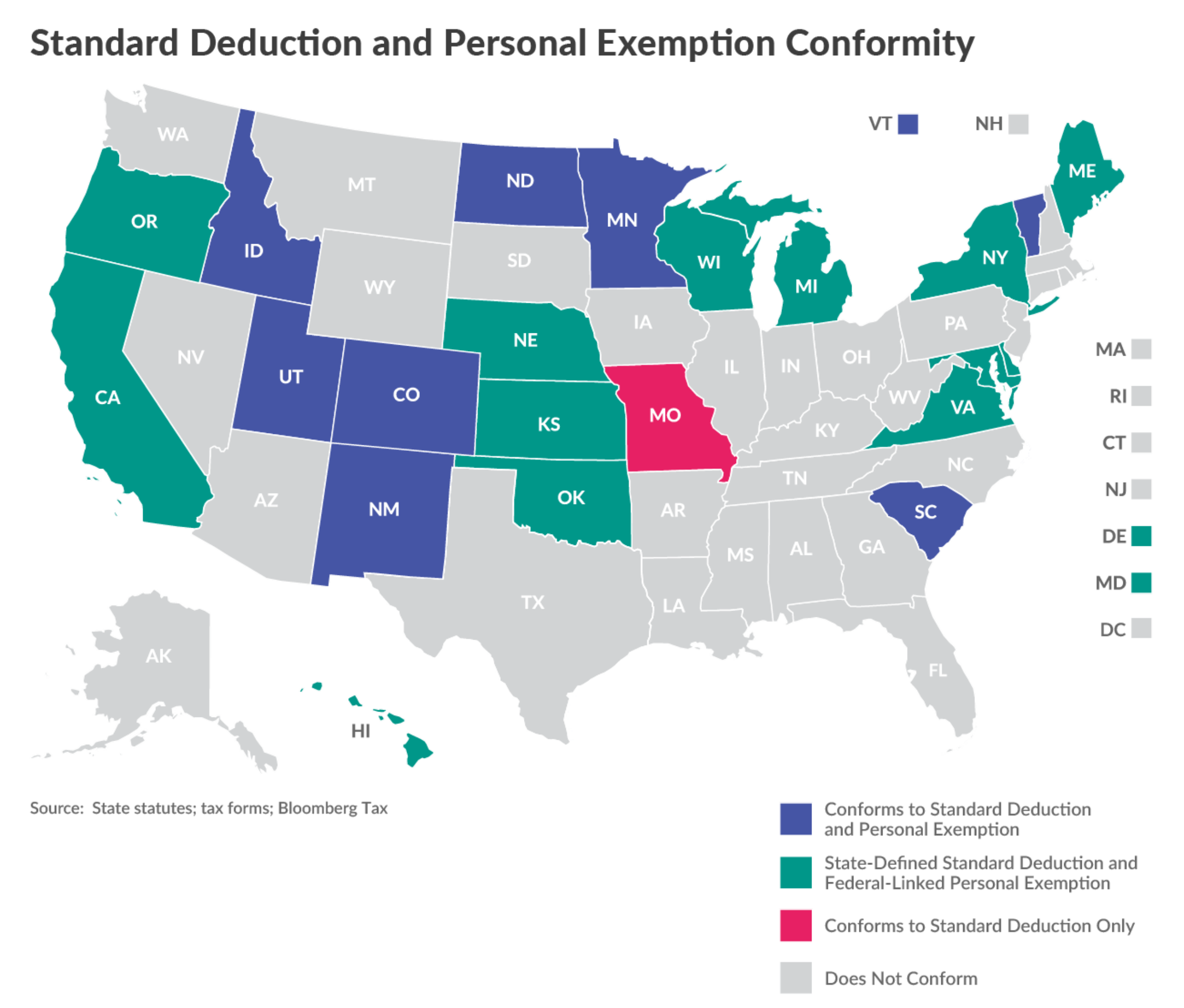
FIVE SOURCES OF NEW REVENUE



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FIVE SOURCES OF NEW REVENUE

- Filing uniformity requirements
  - Filing status linkage
    Thirty-one states, including CT, DE, ME, MD, MA, NJ, NY, RI, VT
  - Itemization linkage
    Eight states plus D.C., including ME

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FIVE SOURCES OF NEW REVENUE

- International income
  - Subpart F income
    Thirteen states, including NH, NY, VT (no guidance in NJ)
  - Dividends Received Deduction
    Twenty-six states plus D.C., including ME, MD, RI, NH
  - New Federal Anti-Abuse Provisions
    FDII, GILTI, and BEAT

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FIVE SOURCES OF NEW REVENUE

- Dynamic economic effects
  - Some provisions of the new federal law are likely to encourage additional domestic investment
    - Temporary full expensing of short-lived capital investments (machinery and equipment)
    - Higher Section 179 limits
    - Lower corporate rate
    - Territorial taxation (cuts both ways)
  - This may lead to additional economic activity in states, particularly if they optimize their tax codes for it

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REVENUE IMPLICATIONS

- States anticipating revenue gain
  AZ, CO, GA, ID, IN, IA, LA, ME, MD, MA, MI, MN, NE, NY, PA, SC, VT, WA, DC
- States anticipating revenue loss
  MO – conforms to standard deduction but not personal exemption
  ND – incorporates pass-through deduction
  OR – incorporates pass-through deduction
- Still waiting on revenue reports from other states
  Expectation is that all remaining states would see revenue gains

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SALT CAP WORKAROUNDS

- Several states are trying to enable their taxpayers to avoid the new $10,000 SALT deduction cap

- Two primary approaches –
  - Charitable contributions in lieu of taxes
    Faces an uphill legal battle
  - Voluntary payroll tax with offsetting credit
    Likely legal but with major administrative challenges

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OPTIONS FOR STATES

- Decouple from the pass-through deduction
- Couple to new expensing rules
- Enhance federal conformity
- Use one-time revenues wisely
- Enact comprehensive tax reform

QUESTIONS?

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