The State Tax Implications of Federal Tax Reform Legislation

Executive Committee Task Force on State and Local Taxation

Phoenix, Arizona

January 14, 2017

Joe Crosby, Multistate Associates

Karl Frieden, Council On State Taxation

Michael Mazerov, Center on Budget and Policy Priorities

Greg Turner, Turner SALT

Prospects for Sweeping Federal Tax Reform

Favorable Factors

- Republican control of the Presidency and Congress
- Strong support of Speaker of the House Paul Ryan
- Compatibility with President-elect Trump’s trade and job creation policies
- The House Blueprint
- International tax pressures on the US

Potential Obstacles

- What happens in the Senate?
- Conflict over the border adjustability provision and other parts of the package
- Competition with other legislative priorities
- The mixed historical record of enacting comprehensive tax reform

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

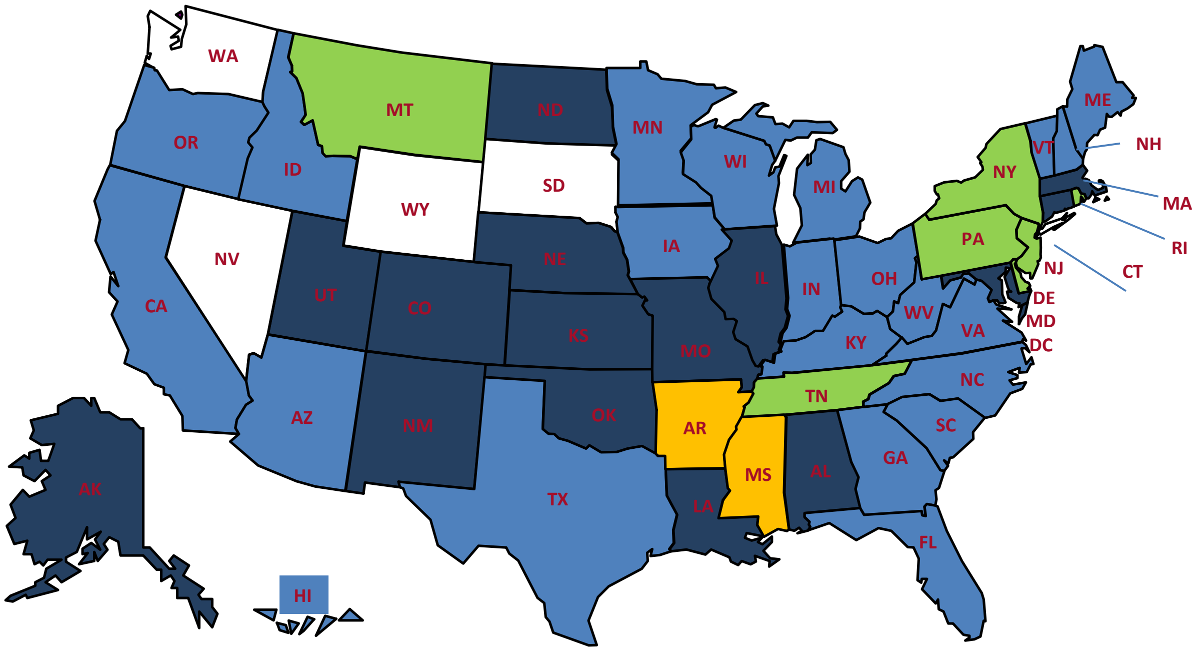
Federal

- Reduce the top CIT rate
- Broaden the CIT tax base
- Border adjustability
- Expensing investments
- Reduced repatriation rate
- Territorial tax regime
- Reduce flow through rate
- Other PIT changes

States

- States have own rates
- State conformity
- State conformity
- State conformity
- Minimal impact
- Minimal conformity
- States have own rates
- States have own rates, but conform to base broadening

State IRC Conformity: The Starting Point



- Current (Rolling)
- Fixed Date
- Does not incorporate the IRC by reference, but uses Federal Taxable Income as the starting point
- Conforms only to specified sections
- No corporate income tax – N/A

Notes

AR – only specified sections adopted; various dates
AZ – 1/1/16
CA - 1/1/15
CT – last day of income year
FL – 1/1/16
GA – 1/1/16
HI - 12/31/15
IA – 1/1/16
ID – 1/1/16
IN – 1/1/16
KY – 12/31/15
MD – Current unless impact to state of $5MM or more
ME – 12/31/15
MI – 1/1/12
MN – 12/31/14
MS – current, but only specified sections adopted
NC – 1/1/16
NH – 12/31/00
OH – 4/1/15
OR – 12/31/15
PA – various provisions adopted current and FTI starting point.
SC - 12/31/15
TX – tax year beginning 1/1/07
VA – 12/31/15
VT – In effect for 2015
WI – 12/31/13
WV – 12/31/15

Examples of State Non-Conformity with the Internal Revenue Code

- IRC 168(k) provided **bonus depreciation** for eligible property purchased between 2002 and 2020
  - Was originally passed in 2002 as part of the Job Creation and Worker Assistance Act and was last amended with 2015's Protecting Americans from Tax Hikes Act (PATH Act)
  - 15 states conform with 168(k)
  - **31 states do not conform** with 168(k)

- IRC 179 provides for **first-year expensing** of small business capital investment, currently set at up to $500,000
  - 46 states generally conform with IRC 179 expensing
  - **11 states do not conform with IRC 179 expensing limits**, instead imposing lower limits, ranging from $25,000 to $250,000

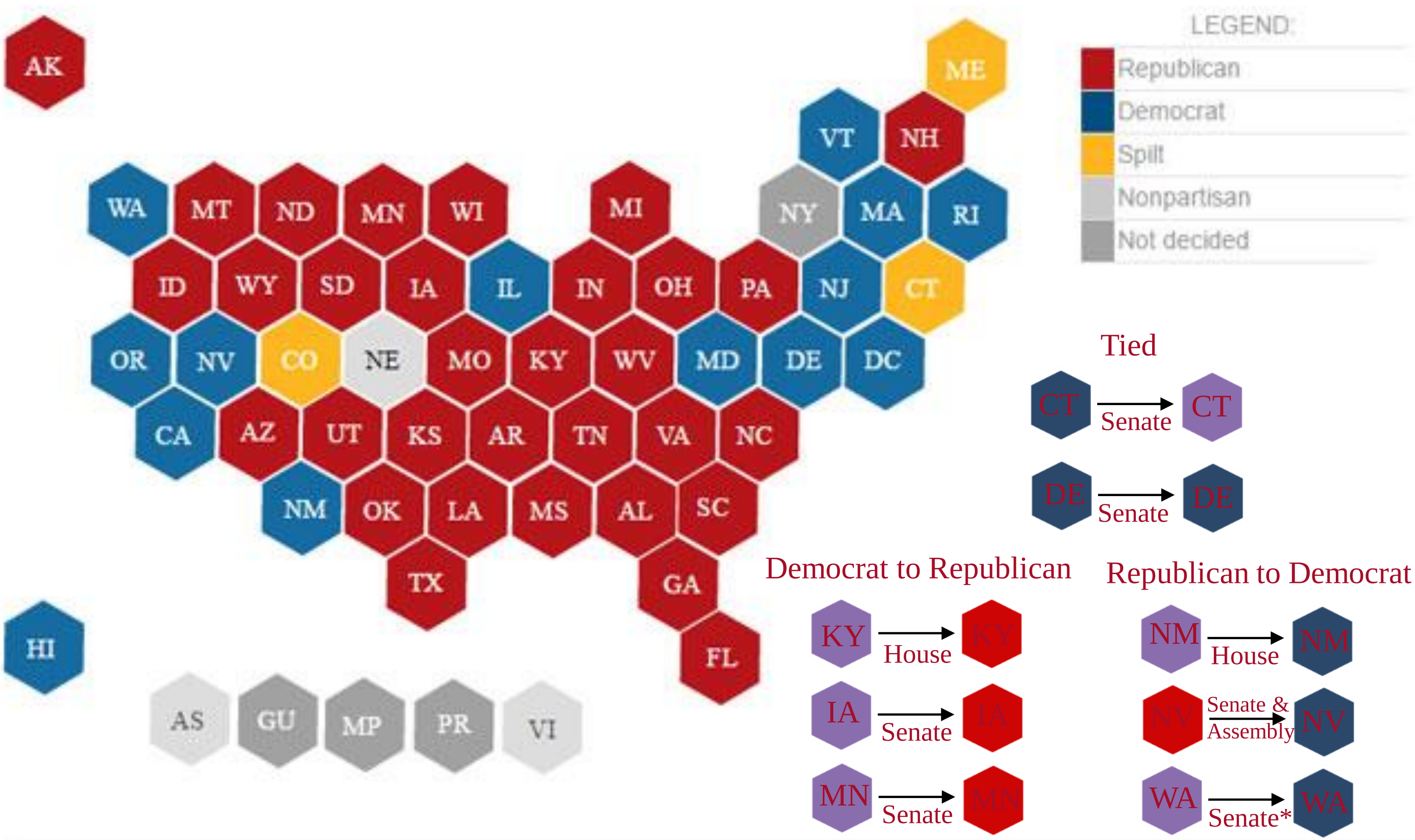
Fiscal Impact on the States

- **States do not generally conform to some of the Blueprint's major revenue loss provisions:**
  - Corporate, personal income, flow through entity, and unearned income tax rate reductions.
- **States are likely to receive significant revenue increases from conformity with other Blueprint provisions:**
  - Border adjustability; disallowance of interest deductions; elimination of many corporate and personal income tax deductions
- **Will some states opt out of certain revenue losing provisions** (e.g. expensing of investments), even though the aggregate impact is likely to result in a revenue increases.
- **What will the states do with potential revenue windfalls**
  - Based on current state conformity with the IRC, there is likely to be a revenue windfall for the states if the Blueprint passes.
  - Will states reduce rates or otherwise attempt to make the overall impact revenue neutral?

Lessons from the Past: Differences with the Tax Reform Act of 1986

- The 1986 Act took several years to enact – but the Presidency and Congress were in different party control.
- The 1986 Act was focused more on rate reductions and base broadening, not on more transformative changes such as the shift from a "origin-based" net income tax to a "destination-based" cash flow tax; and a shift to territorial taxation.
- The 2017 federal tax reform package will have significant implications for states sales tax.
  - What happens if the federal government shifts its income tax to a more consumption tax-base approach?

2016 Post- Election State Legislative Control



Source: National Conference of State Legislatures

* WA - Republicans will have functional control as one Democrat will caucus with the Republicans.