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# THE TAX DEBATE MOVES TO THE STATES: THE TAX CUTS AND JOBS ACT CREATES MANY QUESTIONS FOR STATES THAT LINK TO FEDERAL INCOME TAX RULES

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Taxes defined Congress's agenda for much of 2017, culminating in passage of the Tax Cuts and Jobs Act (TCJA) in late December. Because of that new federal law, taxes will dominate many state legislative sessions in 2018. The TCJA changed many federal tax provisions, and how states choose to respond will have big effects on their tax revenue and taxes paid by their residents.

Much has been said about the law's cap on the federal tax deduction for state and local taxes, and rightfully so as many states will need to determine whether they should maintain the same level and structure of taxes as before. But TCJA included several other provisions that will significantly affect many states, because most states link their state income tax to federal rules and will thus need to decide whether to let the federal changes flow through to their state system or decouple and establish new rules. Further, states will need to make these decisions while preparing for the inevitable pressure on federal spending programs resulting from the TCJA's $1.5 trillion increase in projected federal budget deficit over the next 10 years.

In this brief, we explain why and how states link to federal individual income tax rules. We then describe how previous federal tax changes affected states and why the TCJA differs from a predecessor it is often compared to—the Tax Reform Act of 1986.

Although the TCJA will affect nearly every state with an income tax, the biggest changes are concentrated in states that use federal taxable income (Colorado, Minnesota, North Dakota, South Carolina, and Vermont) or that use the federal standard deductions and/or personal exemptions (the District of Columbia, Idaho, Maine, Missouri, Nebraska, New Mexico, and Utah) in their income tax calculations. We explain what would happen to revenue and taxpayers in these states if they do not enact legislative changes and describe how these states might change their tax systems in response to the TCJA.

## HOW AND WHY DO STATES LINK TO FEDERAL INCOME TAX LAWS?

States have piggybacked on the federal individual income tax code in various ways since the tax was introduced over a century ago. In fact, some states originally levied state income taxes simply as a percentage of a resident's federal tax liability (Mason 2013). North Dakota, Rhode Island, and Vermont used this calculation as recently as 2001 (Duncan 2005).

Today, most states connect to the federal code through their definitions of income. Of the 41 states with a broad-based individual income tax, 30 and the District of Columbia start their income tax calculations with federal adjusted gross income (AGI), and five use federal taxable income (table 1).[1] The former is a taxpayer's gross income after "above-the-line" adjustments, such as deductions for individual retirement account (IRA) contributions and student loan interest, and the latter is that total minus personal exemptions and minus the standard or itemized deductions, such as mortgage interest or charitable contributions.[2] States that use federal AGI but not taxable income have their own rules for standard and itemized deductions and personal exemptions.

TABLE 1

### State Individual Income Tax Starting Points

How states link to the federal tax code with definitions of income

| | | | | |
|---|---|---|---|---|
| **Federal taxable income** | | | | |
| Colorado | Minnesota | North Dakota | South Carolina | Vermont |
| **Federal adjusted gross income** | | | | |
| Arizona | California | Connecticut | Delaware | District of Columbia |
| Georgia | Hawaii | Idaho | Illinois | Indiana |
| Iowa | Kansas | Kentucky | Louisiana | Maine |
| Maryland | Michigan | Missouri | Montana | Nebraka |
| New Mexico | New York | North Carolina | Ohio | Oklahoma |
| Oregon | Rhode Island | Utah | Virginia | West Virginia |
| Wisconsin | | | | |
| **State definition of income** | | | | |
| Alabama | Arkansas | Massachusetts | Mississippi | New Jersey |
| Pennsylvania | | | | |

**Source:** Federation of Tax Administrators; state statutes.
**Note:** Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax individual income. New Hampshire and Tennessee tax only interest and dividends.

Only Alabama, Arkansas, Massachusetts, Mississippi, New Jersey, and Pennsylvania do not use either federal starting point. But even these states often refer to Internal Revenue Service (IRS) rules and definitions to establish their income tax bases. For example, these states ask filers to list income amounts from their federal W-2 and 1099 forms on their state return.

A state's connection to federal AGI or taxable income is either "static" or "rolling." A static (or fixed-date) link uses federal laws as of a specific date defined in state legislation. Minnesota, which begins with federal taxable income, currently uses federal tax law as it was on December 16, 2016. To conform with federal changes passed after that date, Minnesota (and all other static states) must pass legislation to establish a new conformity date. Alternatively, a rolling (or current) link means a state's laws automatically update whenever federal law changes. If these states disagree with a federal change, they must pass a law to decouple from the federal legislation. Among the states that begin with federal AGI, 15 are static and 15 and the District of Columbia are rolling. Among states that begin with federal taxable income, three are static and two are rolling (table 2).

**TABLE 2**

## Where States Link to the Federal Tax Code

### Static versus rolling

| | | | | |
|---|---|---|---|---|
| **Static/fixed-date** | | | | |
| Arizona | California | Georgia | Hawaii | Idaho |
| Indiana | Iowa | Kentucky | Maine | *Minnesota* |
| North Carolina | Ohio | Oregon | *South Carolina* | *Vermont* |
| Virginia | West Virginia | Wisconsin | | |
| **Rolling/current** | | | | |
| *Colorado* | Connecticut | Delaware | District of Columbia | Illinois |
| Kansas | Louisiana | Maryland | Michigan | Missouri |
| Montana | Nebraska | New Mexico | New York | *North Dakota* |
| Oklahoma | Rhode Island | Utah | | |

**Source:** Federation of Tax Administrators; state statutes.
**Notes:** States that use federal taxable income are italicized. States that use their own definition of income and states that do not tax individual income are not included.

In addition to definitions of income, states use other parts of the federal tax law in their codes. The District of Columbia, Idaho, Maine, Missouri, Nebraska, New Mexico, and Utah all begin with federal AGI, then directly link to the federal standard deduction, personal exemption, or both. Therefore, filers claim the same amount for these provisions on their state return as they do on their federal return.

States also link to the federal child tax credit (CTC), child and dependent care tax credit (CDCTC), and earned income tax credit (EITC). Twenty-eight states and the District of Columbia have their own EITC, 22 states and the District of Columbia have a CDCTC, and four states have a state-level CTC.[3] States typically provide these tax benefits as a percentage of the federal amount. State EITCs range from 3 percent of the federal credit in Montana to a nonrefundable 125 percent credit in South Carolina. (The highest refundable credit is 40 percent in the District of Columbia.) But states can also offer these credits with different formulas. In North Carolina, the state uses the federal CTC to establish eligibility but then provides a flat $100 credit per eligible child.

When states link to the federal code, it benefits both their residents and their government's tax administrators. Using federal rules and definitions simplifies state returns for taxpayers, who only need one set of documents and calculations for both their federal and state returns. Different states using the same federal laws also helps residents who earn income in multiple states. On the administrative side, states that use the federal code can rely on the IRS, Treasury Department, and federal courts for regulation, guidance, liability determinations, and compliance. With an intricate and complex system already established, states have "an almost irresistible incentive" to levy income taxes that draw on the federal system (Stark 2010).

However, heavy reliance on the federal government takes a degree of autonomy away from states. When Congress changes federal tax law, state tax law also often changes, and those changes may not always be consistent with each state's values or budgets. This forces states to choose between keeping conformity and its built-in simplicity or decoupling and establishing new rules. And on rare occasions, federal changes can, for better or worse, completely upend a state's entire income tax system.

## RECENT FEDERAL TAX CHANGES AND THE STATES

Most recent federal individual income tax legislation did not significantly alter the federal government's definition of income and thus did not require state responses. For example, the Economic Growth and Tax Relief Reconciliation Act of 2001 was a major tax bill, but it mostly lowered federal taxes by cutting tax rates. The resulting revenue loss motivated North Dakota, Rhode Island, and Vermont to stop calculating their state tax as a percentage of federal liability, but all other states were unaffected because no other state tied its tax rates to the federal rates.

Other recent federal laws produced small and easily managed changes for states. The 2009 American Recovery and Reinvestment Act expanded the federal EITC, which meant states that piggybacked on the federal credit also expanded their credit both as a benefit for filers and as a cost for state revenue. However, the revenue loss was relatively low for states, and a state could easily lower its matching percentage to reduce the cost. New Jersey was the only state that lowered its match in 2010, but it's difficult to discern whether that was in response to the federal EITC change or larger budget problems created by the Great Recession.

One example of states choosing not to follow the federal lead was in 2002, when the Job Creation and Worker Assistance Act of 2002 enacted bonus depreciation, which allowed taxpayers to immediately deduct 30 percent (later raised to 50 percent) of the cost of new investment in machinery and equipment. More than half the states with a broad-based personal income tax decoupled from this federal provision and disallowed the bonus depreciation deduction.

## THE TAX REFORM ACT OF 1986

The last major federal change to the definitions of income was the Tax Reform Act of 1986, which increased the standard deduction and personal exemption and repealed many deductions and exclusions in the federal code. The subsequent state legislative action the following year was so great that a National Conference of State Legislatures report called it "The Blizzard of 1987" (Gold 1988).

Of the 40 states with a broad-based income tax in 1987,[4] 39 conformed with the federal changes to definitions of income that year, and Kentucky, the lone holdout, did so in 1988 when it held its regular legislative session. Colorado and Minnesota went even further and adopted federal taxable income as their starting point in response to the 1986 federal law.

Adopting federal tax reforms occurred on mostly good terms for the states in 1987 because, by conforming, all the federal base-broadening measures in the 1986 law flowed through to the state tax systems and thus created a revenue windfall. The big question facing state lawmakers in 1987 was whether to pocket the new revenue and spend it on services, such as education and transportation, or use the new funds to follow the federal government's lead and cut and simplify state taxes.

Many chose tax cuts: In 1987, 14 states reduced income tax rates, 11 eliminated tax brackets, 18 increased personal exemptions or personal credits, and 20 increased standard deductions. In total, 30 states made changes to their income tax (beyond conforming to the federal law) and five completely restructured their income tax.[5] Eleven states maintained the revenue windfall and did not pass some type of tax cut (Gold 1988).

At the beginning of 2017, some states hoped federal tax efforts would again provide them with a windfall because of base broadening, but the bill that eventually passed Congress in December 2017 is very different from 1986's reform.

## TAX CUTS AND JOBS ACT

The TCJA, signed into law by President Donald Trump on December 22, 2017, makes many changes to the federal tax code. However, unlike the Tax Reform Act of 1986, the TCJA does not significantly broaden adjusted gross income, the starting point for the individual income tax base. Some of the deductions and exclusions repealed, such as those for moving expenses, alimony paid, and bicycle commuting expenses, are little more than a rounding error in the $1.5 trillion bill. Others, such as the repeal of the deduction for income from domestic productions activities or the limit on deductible business losses, affect relatively few individual taxpayers. Thus, states that use federal AGI for their income tax base will see little revenue change if they conform, and they certainly will not see the windfall that followed the 1986 reform.

But the TCJA does contain changes that will significantly affect income taxes in some states and that may inspire major state legislative action. These include

- increasing the federal standard deduction from $6,500 to $12,000 for single filers, $9,550 to $18,000 for head-of-household filers, and $13,000 to $24,000 for married filers;
- eliminating personal exemptions by lowering their value from $4,150 to $0;
- raising the CTC from $1,000 to $2,000 per eligible child, increasing the maximum refundable amount from $1,000 to $1,400, and raising the income level at which the credit begins to phase out from $110,000 to $400,000 for joint filers and from $75,000 to $200,000 for other taxpayers;[6]
- creating a $500 credit for non-CTC-eligible dependents;
- providing a 20 percent deduction for qualifying pass-through business income;
- limiting the deduction for state and local taxes to $10,000; and
- eliminating the mortgage interest deduction for interest on mortgage debt over $750,000.

The elimination of personal exemptions, the increase in the standard deduction, and the limit on itemized deductions will, on net, increase federal taxable income. These changes will not directly affect states that start with federal AGI for their income tax, but they will affect those that link to federal taxable income or to federal standard deductions or personal exemptions. Those states will need to decide whether to conform to the federal changes. A further complication is that all individual income tax provisions of the TCJA are scheduled to sunset after December 31, 2025, except for the provisions designating an alternative inflation measure for indexing the tax system. The potential impermanence of the federal changes is another factor states will need to consider.

### *Standard Deduction and Personal Exemptions*

The TCJA's changes to the standard deduction and personal exemption are unprecedented. The 1986 Tax Reform Act increased the standard deduction for married filers by $1,240, or about one-third. The TJCA almost doubles it. Filers have claimed personal exemptions since the income tax's inception. The TJCA eliminates them and replaces some of the tax benefit with other credits and the larger standard deduction.

This leaves questions about maintaining conformity for the 11 states and District of Columbia that link to federal standard deductions and personal exemptions (table 3).

TABLE 3

## States That Link to Federal Government's Standard Deductions and Personal Exemption

| Standard deductions and personal exemption | | | | |
|---|---|---|---|---|
| *Colorado* | District of Columbia | Idaho | *Minnesota* | New Mexico |
| *North Dakota* | *South Carolina* | Utah | *Vermont* | |
| **Standard deductions** | | | | |
| Missouri | Nebraska | | | |
| **Personal exemption** | | | | |
| Maine | | | | |

**Source:** State statutes.
**Notes:** States that use federal taxable income are italicized. Utah links to the federal personal exemption but filers receive 75 percent of its value.

Missouri and Nebraska link to the federal standard deductions but not the federal personal exemption. If they maintain conformity, the higher standard deduction amounts would greatly benefit state taxpayers by reducing their taxable income, but that would come at a great cost to state revenue. Maine, which links to federal personal exemptions but not federal standard deductions, faces the opposite issue if it maintains conformity: lowering its personal exemption amount from $4,150 to $0 would raise taxable income and lead to a large tax increase on residents, but it would produce significant additional state tax revenue.

Colorado, the District of Columbia, Idaho, Minnesota, New Mexico, North Dakota, South Carolina, Utah, and Vermont link to both federal provisions and thus would experience both effects if they maintain conformity. This would create winners and losers for state taxpayers. Filers claiming a personal exemption only for themselves (and, if married, for their spouse) would get a state tax cut (if they do not itemize deductions) because the larger standard deduction would reduce their taxable income more than the increase from the loss of personal exemptions. However, families claiming personal exemptions for two or more dependents would get a tax increase because the loss of personal exemptions is greater than the increase in their standard deduction. Families who itemize deductions would lose the value of the personal exemptions and not benefit from the expanded standard deduction. As for state tax revenue, the changes will vary by state, but the Joint Committee on Taxation estimates that in 2019 the repeal of personal exemptions will increase federal tax revenue ($137 billion) far more than the cost of increasing standard deductions ($82 billion).[7]

Zeroing out the federal personal exemption could also cause problems in other states depending on how the IRS implements the new rule and how states define personal exemptions in their codes. Seventeen states set their own personal exemption amounts but instruct filers to enter the number of personal exemptions from their federal return on their state return (table 4).

TABLE 4

## Federal Personal Exemption Count in States

| Use federal personal exemption count on state return | | | | |
|---|---|---|---|---|
| California | Delaware | Hawaii | Illinois | Indiana |
| Kansas | Louisiana | Maryland | Missouri | Michigan |
| Nebraska | New York | Oklahoma | Oregon | Virginia |
| West Virginia | Wisconsin | | | |

**Source:** State statutes.
**Notes:** Does not include states that begin with federal taxable income or link directly to the federal personal exemption law.

Further, state statutes vary, such as in these examples:

- **Louisiana**: "All personal exemptions and deductions for dependents allowed in determining federal income tax liability, including the extra exemption for the blind and aged, will be allowed in determining the tax liability in this Part."
- **Maryland**: "$3,200 for each exemption that the individual may deduct in the taxable year to determine federal taxable income under 151 of the Internal Revenue Code"
- **New York**: "[E]ntitled to a deduction for the taxable year under section one hundred fifty-one(c) of the Internal Revenue Code"
- **Oklahoma**: "One Thousand Dollars in lieu of the personal exemptions allowed by the Internal Revenue Code.

Whether those provisions would still apply given the changes at the federal level is unclear. For example, a senior economist for Michigan's House Fiscal Agency argues the TCJA eliminated the state's personal exemption; a former deputy budget director argues it did not. Both said they could be mistaken.[8] Regardless, the governor is asking the legislature to change the law to save it.[9] Similarly, Maryland's governor, who is in part concerned with the word "deduct" in his state's code, is also asking the legislature to change its law to ensure personal exemptions remain.[10]

States may be able to maintain personal exemptions without the federal exemption because the federal code preserves provisions that refer to "taxpayers," "spouse," or "dependents" that are allowed a personal exemption under section 151 of the tax code. Thus, states that currently refer to section 151 should be able to continue to provide personal exemptions but may need to modify the specific language in their law.

In states with no connection to the federal law, personal exemptions and credits are provided to the filer, spouse, and dependents, and these terms are defined elsewhere in the state's own code (often using federal definitions).

### *Child Tax Credit and non-Child Tax Credit-Eligible Dependent Credit*

Although it eliminated personal exemptions, the TCJA did not raise taxes on most families with children because it also expanded the CTC and added a dependent credit for dependents not eligible for the CTC (TPC 2017). However, credits do not affect federal taxable income—they are instead subtracted directly from federal tax liability. Thus, unlike the new standard deduction and personal exemption, these changes do not flow through to the five states that define income using federal taxable income.

Only Colorado, New York, and Oklahoma piggyback on the federal CTC. All three offer a state CTC as a percentage of the federal benefit: 5 percent in Oklahoma, 30 percent in New York, and a range between the two depending on income in Colorado (but limited to children younger than age six).[11] The TCJA will increase both the size of the state CTC benefit and number of eligible children in these states unless they act to change the provisions. North Carolina also offers a CTC, using the federal CTC to establish eligibility, but limits its credit to $100 per eligible child. The federal changes to income eligibility should increase the number of eligible children in North Carolina, but it will not increase the size of the state's benefit per eligible child.

States will need to decide whether to follow the federal lead in replacing personal exemptions with expanded child and dependent tax credits or to maintain the features of their current tax system.

### *Deduction for Pass-Through Business Income*

The TCJA did the opposite of base-broadening by allowing taxpayers to claim a 20 percent deduction for qualified business income that they report on their individual income tax returns. Single-owner businesses (sole proprietorships), partnerships, limited liability companies, and certain qualifying corporations do not pay federal income taxes at the business level. Rather, the profits from those businesses are reported on the income tax returns of the owners and are taxed under the individual income tax.[12] The deduction is a significant tax cut for the owners of those businesses. The Joint Committee on Taxation estimates it will cost the federal government roughly $50 billion a year.

Importantly for states, the deduction applies to federal taxable income and not federal AGI.[13] Therefore, the deduction will not flow through to taxpayers in the 30 states and the District of Columbia that define income using federal AGI, and the tax base in these states will not change unless they pass legislation to adopt it.

But the deduction will flow through to the five states that define income using federal taxable income, and it will do so automatically in Colorado and North Dakota because they use rolling conformity. Minnesota, South Carolina, and Vermont will not adopt the deduction unless and until they establish a new conformity date that incorporates the deduction.

If these states want to keep federal taxable income as a starting point but not adopt the pass-through deduction, they could require filers to add back the deduction when calculating state taxable income. Many states required taxpayers to add back the federal deduction for domestic production activities (section 199 deduction) when Congress added that provision to the federal income tax in 2004. The TCJA repealed the section 199 deduction, so the remaining states that did conform will see a small boost to their state taxable income.

States may also choose to conform with the deduction for pass-through business income, but conforming would cost the states considerable tax revenue. The chairman of Minnesota's House Taxes Committee has endorsed this idea.[14]

### *Itemized Deductions*

The major base-broadening measure in TCJA is capping the state and local tax (SALT) deduction at $10,000. The TCJA also places tighter limits on the mortgage interest deduction and eliminates deductions for nondisaster casualty losses and certain miscellaneous expenses. These changes will expand federal taxable income and thus state income tax revenues for those states that use taxable income as their starting point.

The cap on the SALT deduction will not directly affect most state tax systems because nearly all states prevent filers from claiming all or part of the SALT deduction on their state return.[15] However, it could affect the ability of states to raise taxes in the future or even to maintain their current level of taxation. The SALT deduction acts as a federal subsidy to states by decreasing the net cost of taxes for state residents who itemize deductions on their federal income tax return, enabling states to have higher taxes and provide more government services than they otherwise might (Sammartino 2017a).

Some states are exploring alternatives that would allow taxpayers who face the cap on their SALT deduction to deduct those taxes in other ways. One proposal is to reduce state income taxes but make up that revenue with employer payroll taxes, which remain deductible for the employer under the new law, and give employees a state income tax credit equivalent to the payroll tax increase. If employers reduce employee wages to cover the cost of the new payroll tax, workers would see their take-home pay go down, but that decrease would be offset by the income tax credit, leaving their net income after state taxes unchanged. If the payroll tax applied to all wages, this would essentially extend federal deductibility of state taxes to all workers, not just to those who itemize their deductions.

An alternative proposal is to establish special charitable organizations to support specific state and local programs, such as for funding K–12 education, and give taxpayers who donate to these organizations an income tax credit for their donations. This would leave their income after state taxes unchanged and allow them to deduct their charitable contributions on their federal income tax return.

In an odd twist, the TCJA could also increase state taxes in the six states (Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon) that allow state taxpayers to deduct their federal income taxes (with certain limits) from their state taxable income. Because the TCJA cut federal income taxes for most taxpayers, this will increase state taxable income and thus state income taxes in those states. Iowa Governor Kim Reynolds has proposed eliminating the deduction as part of a broader tax-relief package.[16]

### *Simplification and Complexity Issues*

The Tax Policy Center estimates that because of the increases in the standard deduction and the limits on certain itemized deductions, the number of tax filers taking the standard deduction will rise from 74 percent to 89 percent.[17] This will simplify tax filing for many taxpayers who will now claim the standard deduction rather than itemizing their deductions. In 16 states and the District of Columbia, however, if a filer takes the standard deduction on their federal return, they must also take the standard deduction on their state return (table 5).

Tax filers in states with restrictions may need to decide whether it is better to itemize on their federal return even though the total is less than the new standard deduction because the benefits from itemizing at the state level are greater. This would become particularly an issue in states with standard deductions already well below pre-TCJA federal levels, such as Georgia ($7,400 for married filers), Kansas ($4,500 for married filers), and Virginia ($6,000 for married filers).

TABLE 5

## State Standard Deduction and Itemization Rules

Are filers required to follow decisions on the federal return?

| Filers must claim standard deduction on state return if they did on federal return | | | | |
|---|---|---|---|---|
| *Colorado* | District of Columbia | Georgia | Kansas | Maine |
| *Minnesota* | Missouri | Nebraska | New Mexico | New York |
| North Carolina | *North Dakota* | Oklahoma | *South Carolina* | Utah |
| *Vermont* | Virginia | | | |
| **Filers must itemize on state return if they did on federal return** | | | | |
| *Colorado* | District of Columbia | Georgia | *Minnesota* | New Mexico |
| *North Dakota* | Oklahoma | *South Carolina* | Utah | *Vermont* |
| Virginia | | | | |
| **Federal standard deduction and itemization are not binding** | | | | |
| Alabama | Arizona | Arkansas | California | Delaware |
| Hawaii | Idaho | Iowa | Kentucky | Louisiana |
| Maryland | Mississippi | Montana | Oregon | Wisconsin |
| **State does not have standard deduction or itemization** | | | | |
| Connecticut | Illinois | Indiana | Massachusetts* | Michigan |
| New Jersey | Ohio | Pennsylvania | Rhode Island* | West Virginia |

**Source:** State income tax forms and statutes.
**Notes:** States that use federal taxable income are italicized. Massachusetts offers "allowable deductions" but they do not include mortgage interst. Rhode Island does not allow itemization but does have a standard deduction.

## HOW MIGHT STATES RESPOND?

Over the next few weeks, state fiscal offices will publish estimates of what the TCJA will do to state tax revenue and tax burdens without legislative action. In states that only use federal AGI, the resulting changes will be small—they will not receive a windfall this year. But states that use federal taxable income or link to the standard deduction, personal exemption, and itemization rules face big questions about the future of their tax systems. Here are some possible legislative responses.

### *Maintain Tax Conformity*

In most states, maintaining conformity would increase tax revenue (Missouri and Nebraska are exceptions), although for states that start with federal AGI, the increase would be small. Still, states would face essentially the same question they did in 1987: should they keep the new revenue for spending priorities or use it to reduce taxes?

In late December, Colorado's Democratic Governor John Hickenlooper and Republican House Minority Leader Patrick Neville announced a preference for spending some new revenue from the federal tax bill on transportation.[18] And legislators in several other states have said this revenue could fund other state needs or make up for looming federal budget cuts.

However, the TCJA presents a major complication in 2018 that did not exist in 1987 that is sure to get attention in state capitols: who pays for the new revenue? In 1987, the new revenue came from many groups losing tax preferences. This year, in states that start with federal taxable income or use the federal standard deduction and personal exemption, the main losers from conformity would be large families with several dependents because of the loss of personal exemptions. Idaho Senate President Pro Tem Brent Hill said he cannot imagine his state's legislature accepting such a tax hike.[19] Any state planning on spending a windfall should figure out who is paying for it.

State tax limits present another complication. Colorado's Taxpayers Bill of Rights (TABOR) restricts revenue growth, so some of the revenue from the federal changes might have to be returned to taxpayers. Missouri also has limits on revenue growth, and Idaho, South Carolina, and Utah have appropriation limits that could prevent states from keeping and spending revenue from the federal changes (Randall and Rueben 2017).

### *Increase Tax Conformity*

If states want to prevent tax hikes on large families, they could increase their conformity and link to the new federal CTC and dependent credit. However, fully conforming with the new federal changes could end up costing states tax revenue. According to the Joint Committee on Taxation, the combined effect of increasing the standard deduction, eliminating personal exemptions, increasing the child tax credit, and creating the dependent credit will cost the federal government $13 billion in 2019. States with strict balanced-budget requirements, such as Colorado, Idaho, Maine, Minnesota, North Dakota, and South Carolina, would then need to raise other taxes or cut spending programs to offset revenue losses from increased conformity.

In Maine, which currently links to the federal personal exemption but not the standard deduction, House Republican Leader Ken Fredette has proposed increasing conformity. His bill (L.R. 2478) maintains conformity and allows the personal exemption to expire but enacts a Maine CTC that equals the federal CTC and increases Maine's EITC match from 5 percent to 10 percent. There is not yet a cost estimate for the legislation.

Idaho's Senate President Pro Tem Brent Hill said his state is also considering maintaining conformity and adding a CTC.[20] Idaho Governor Butch Otter endorsed "a plan to enable Idaho's substantial conformance with the new federal tax code" in his State of the State address.[21] But these are both clearly tax cuts with no offsetting revenue increases or spending reductions specified.

Additionally, the impermanence of the federal income tax changes might make increasing conformity more difficult. All the individual income tax provisions in TCJA (except the new inflation adjustment formula) are scheduled to expire after 2025. Although Republican supporters of the legislation pledge to maintain these provisions, and Democratic opponents may be hesitant to oppose continuing these particular provisions, there is still a large degree of uncertainty in future federal tax policy. Any state that attempts to maintain and increase conformity could see these federal tax provisions substantially change again in only a few years.

### *Decouple*

States could circumvent the negative consequences of the federal changes by decoupling from the federal law and creating their own specific rules for taxable income, standard deductions, personal exemptions, and itemization. However, this option would make state taxes more complicated, and the new rules would likely create winners and losers.

Oklahoma has already done this. The state previously linked its standard deduction with the federal amounts (its personal exemption was not linked), but anticipating a federal increase, the state decoupled and froze its standard deductions at the federal levels for tax year 2017 (i.e., $6,350 for single filers, etc.).[22] These amounts are not adjusted with inflation going forward and thus will not change until the state passes new legislation. This results in a small tax increase for Oklahoma filers taking the standard deduction. The Oklahoma Tax Commission estimates the change will increase revenue $4 million in fiscal year 2018 and $14 million in fiscal year 2019.[23]

The District of Columbia, Idaho, Maine, Missouri, Nebraska, New Mexico, and Utah all face similar questions. They could follow Oklahoma's lead and freeze their current levels, establish completely new levels (with or without inflation adjustments), or completely change how they exempt income from taxation.

Colorado, Minnesota, North Dakota, South Carolina, and Vermont could all stop using federal taxable income and instead begin their calculations with federal AGI. They then would have to establish new, independent amounts for their standard deduction and personal exemptions and create state rules for itemized deductions. The effects on state revenue and tax burdens would depend on the new design.

### *Overhaul Their Tax Systems*

As in 1987, some states could decide to use the new federal law as an opportunity to completely overhaul their individual income tax or their entire state tax system. However, this may prove more difficult in 2018. Most state reform efforts in 1987 mirrored the revenue-neutral federal changes: cutting rates and eliminating brackets because the tax base was larger. If states mirrored federal efforts this year, they would pass massive, revenue-losing tax cuts. And it's far more difficult to pass such cuts in states because of balanced budget requirements. Instead, they will need far more creative solutions if they want to use the federal tax bill to introduce a new, revenue-neutral tax system.

Another complication is preparation. The National Conference of State Legislatures report noted that many states prepared for 1987's reforms in the decade prior with tax commissions that recommended many of the changes implemented that year. In sharp contrast, none of the state tax commission reports over the past decade have discussed eliminating personal exemptions, and conformity (if mentioned at all) was presented as a positive step for state tax systems. Instead, many recent commissions advocated for income tax cuts (Auxier 2016). Not surprisingly, state tax reform proposals in response to the TCJA center on just that.

The governors of Idaho and South Carolina have both proposed legislation that would maintain conformity and use some of the revenue (from losing personal exemptions) to cut tax rates. Governor Butch Otter would lower both Idaho's top individual income tax rate and corporate tax rate,[24] while Governor Henry McMaster wants to lower each of South Carolina's five tax brackets by 1 percent (over five years).[25] State fiscal offices in both states said the plans would lose revenue: $97 million in Idaho and $140 million in South Carolina in their first fiscal year.

It depends on the design of the legislation, but cutting income tax rates and eliminating personal exemptions would probably create both winners (mostly high-income filers) and losers (mostly low- and middle-income families with multiple dependents).

In Missouri, State Senator Bill Eigel's major reform legislation (L.R. 4085S.07I) decouples Missouri from the federal standard deduction and sets the amount at its 2016 level, ends the state's deduction for federal taxes, and lowers individual income tax rates (along with an increased motor fuel tax rate, caps on tax credit payments, and other changes).[26] There is not yet a cost estimate for the legislation.

## CONCLUSION

When Congress passed the TCJA, it not only created new tax laws for many states, it also created many problems for state policymakers to figure out. And those problems are not easily solved: This is not 1987, there is no revenue windfall, and the states most affected by the law—those facing big changes to their systems if they do not act—cannot enact simple policy changes to increase spending or cut tax rates without significantly increasing tax burdens for specific groups, such as large families. Instead, these state governments must think hard about large tax changes and their effects on both taxpayers and state revenues.

Increasing the pressure, the federal tax bill created a deadline. The federal changes go into effect in calendar year 2018, meaning many state laws need to be updated for tax filing in 2019, if not sooner. State legislatures only meet for a few months in many states, which means that governors, state legislators, and fiscal staffers must all work quickly to evaluate how the new law affects their state and what proposed changes would mean.

All of this occurs as state revenues are improving at a modest rate, but states are struggling to pass budgets (10 failed to pass them on time in fiscal year 2017), and possible federal spending cuts could make the budget math all the more difficult. And, of course, Congress may significantly change the federal tax laws again in the near future.

Over the next few months, states need to make many decisions about their long-term fiscal future. Just as in Congress, however, the new tax law probably created more questions than answers. States will most likely be dealing with its ramifications for the next several years.

## NOTES

[1] New Hampshire taxes only interest and dividends, and Tennessee taxes only bond interest and stock dividends. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not tax individual income of any kind.

[2] Idaho is sometimes listed as using federal taxable income because it uses the federal standard deduction, personal exemption, and itemized deductions. However, Idaho makes some modifications to federal AGI before these calculations to establish Idaho taxable income, so it is listed as starting with federal AGI.

[3] Tax Credits for Workers and Their Families, “State Tax Credits,” accessed January 16, 2018, http://www.taxcreditsforworkersandfamilies.org/state-tax-credits/#1468434107561-be99920d-11c4.

[4] In 1987, Connecticut only taxed interest, dividends, and capital gains.

[5] The National Conference of State Legislatures defined “restructured” as “adopted wholely new rate structures and made major changes in standard deductions and personal exemptions or credits, as well as other changes.”

[6] For more details on the how the child tax credit works, see Tax Policy Center, “What Is the Child Tax Credit?” Tax Policy Center Briefing Book, accessed January 18, 2018. http://www.taxpolicycenter.org/briefing-book/what-child-tax-credit-ctc.

[7] Joint Committee on Taxation, “Estimated Budget Effects Of The Conference Agreement For H.R.1, The "Tax Cuts And Jobs Act," submitted December 18, 2017, accessed January 23, 2018. https://www.jct.gov/publications.html?func=startdown&id=5053

[8] Michael Gerstein, “Economists Spar on What New Tax Law Means for State,” *Detroit News*, January 2, 2018. http://www.detroitnews.com/story/news/politics/2018/01/02/economists-federal-tax-law-michigan/109106460/.

[9] Melissa Nann Burke and Jonathan Oosting, “Synder Proposes ‘Fix’ to Prevent Tax Hike,” *Detroit News*, January 8, 2018. http://www.detroitnews.com/story/news/local/michigan/2018/01/08/michigan-boost-personal-tax-exemption/109271148/.

[10] Michael Dresser and Erin Cox, “Gov. Larry Hogan Says He Will Submit Legislation to Protect Maryland Taxpayers from Federal Overhaul,” *Baltimore Sun*, December 20, 2017. http://www.baltimoresun.com/news/maryland/politics/bs-md-hogan-taxes-20171220-story.html#nws=true.

[11] Colorado’s CTC ranges from 5 percent to 30 percent of the federal CTC depending on income and is not available to filers with more than $85,000 in income or children older than age 5. New York’s CTC is 33 percent of the federal CTC or $100 multiplied by qualifying children (whichever is higher), but the child must be age 4 or older. Oklahoma’s CTC is 5 percent of the federal CTC. http://www.taxcreditsforworkersandfamilies.org/state-tax-credits/#1468434105770-44f9c6c5-52e0.

[12] For more on the taxation of pass-through businesses, see Sammartino (2017b)

[13] Tax Cuts and Jobs Act Conference Report for the Tax Cuts and Jobs Act, H.R. 1, 115th Congress (2017). http://docs.house.gov/billsthisweek/20171218/CRPT-115HRPT-466.pdf.

[14] J. Patrick Coolican, "High-Stakes Debate Coming to Minnesota Legislature after Federal Tax Changes," *Minnesota Star Tribune*, January 6, 2018. http://www.startribune.com/high-stakes-debate-coming-to-minnesota-legislature-after-federal-tax-changes/468224283/.

[15] In 2016, Arizona, Georgia, Hawaii, Louisiana, and North Dakota allowed filers to claim the federal deduction for state and local taxes paid on their state return (Institute on Taxation and Economic Policy 2016).

[16] "Gov. Reynolds Delivers Condition of the State Address." January 9, 2018. https://governor.iowa.gov/2018/01/gov-reynolds-delivers-condition-of-the-state-address.

[17] Tax Policy Center, "Impact on Itemized Deductions of The Tax Cuts and Jobs Act (Jan 2018)," accessed January 18, 2018, http://www.taxpolicycenter.org/simulations/impact-itemized-deductions-tax-cuts-and-jobs-act-jan-2018

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[26] Missouri S.B. 617, 99th general assembly (2017). http://www.senate.mo.gov/18info/BTS_Web/Bill.aspx?SessionType=R&BillID=69472991

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