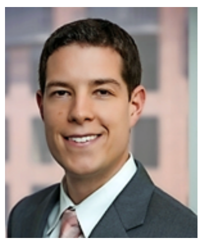
Bloomberg BNA

Daily Tax Report™: State

Tax Policy

Current discussions about federal tax reform include a number of proposals that could impact the states. These items may broaden the tax base and increase state revenue, or put pressure on states to cut taxes and reduce revenue, or even create administrative challenges for states. In this article, the Urban Institute's Kim Rueben, Frank Sammartino, and Richard C. Auxier discuss these proposals and what they mean for the states.

How Federal Tax Changes Would Affect the States



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Just like individual taxpayers and businesses, state governments are closely watching Congress as it debates a tax bill. Most state income tax systems are linked to federal rules and definitions, so federal changes will affect state revenues and possibly force states to change their own tax laws.

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Eliminating federal tax expenditures broadens state income tax bases, which could increase state income tax revenue. But eliminating the federal tax deduction for state and local taxes could pressure states to cut taxes and thus reduce revenue.

Other proposed federal changes could create administrative challenges for state and local governments. For example, if the federal estate tax is eliminated, states might not be able to administer and enforce their own tax.

At the moment, many aspects of the tax plan are unspecified. However, the Tax Policy Center's preliminary analysis of the ''Unified Framework for Fixing Our Broken Tax Code,'' estimated that the plan put forward by the Republican congressional leadership and the White House in September would reduce federal revenue $2.4 trillion over the first decade and by $3.2 trillion over the following 10 years. If a revenue-losing federal tax plan is passed, the president and Congress could choose to offset revenue losses with spending cuts that directly affect state budgets.

 ISSN 1534-1550

Below we discuss what we know about the current tax discussion, what it means for states, and what questions remain.

Individual Provisions

The framework includes the following proposals that would change individual (non-business) income taxes.

- Set individual income tax rates of 12, 25, and 35 percent. (The framework allows for a possible fourth rate above 35 percent).
- Increase the standard deduction to $12,000 for single filers and $24,000 for married filers.
- Repeal all personal exemptions for taxpayers and dependents.
- Expand the child tax credit.
- Repeal most itemized deductions other than those for mortgage interest and charitable contributions.
- Repeal the alternative minimum tax.
- Repeal other exemptions, deductions, and credits.
- Use an alternative measure of inflation to index tax brackets and other tax parameters.

In total, these changes would increase federal revenue by $471 billion over 10 years. The current proposals would eliminate all itemized deductions other than those for mortgage interest and charitable contributions. Because most states use federal definitions for portions of their tax systems, repealing federal exemptions, deductions, and credits would also expand state tax bases. Moreover, with the increase in the standard deduction and the elimination of the state and local tax deduction, far fewer taxpayers would itemize. States will need to consider how they adjust their own deductions and exemptions if the federal amounts radically change. For example, will states allow taxpayers to itemize on their returns if they haven't on their federal tax return?

These changes could increase state tax revenue. In the aftermath of the 1986 tax reform, base-broadening reforms increased state income tax revenue an estimated 20 percent or more in 19 states. However, our estimates of current proposals show much less actual base broadening compared with 1986. We will know more when Congress releases actual legislation.

The largest federal base-broadening reform is eliminating the state and local tax (SALT) deduction, which we estimated would raise $1.3 trillion in federal revenue over 10 years. Most states do not allow filers to claim the deduction on their state taxes, but repeal would still affect state tax systems. The SALT deduction acts as an indirect federal subsidy to state and local governments because it offsets some of the burden of state taxes. If voters decide that state taxes are too high without the federal SALT deduction, it could lead to tax cuts and less revenue.

Overall, eliminating the SALT deduction would increase taxes for about 24 percent of taxpayers, and affect taxpayers in every state. But the percentage with tax increases would be far higher in some states such as Connecticut and Maryland, which have greater percentages of high-income residents and higher state personal income taxes. Because the SALT deduction only lowers the burden for taxpayers who itemize, and those itemizers tend to be high earners, in theory the deduction incentivizes a more progressive state income tax. Thus, ending the SALT deduction could push states away from progressive tax structures. However, given that the accompanying rate cuts would lower federal taxes for high-income taxpayers, this may alternatively leave room for increasing state taxes.

Finally, to the extent that federal marginal tax rates are lowered, the implicit subsidy to state and local municipal debt would also fall. Currently, most state and local borrowing is exempt from federal income tax, which allows state and local governments to borrow more cheaply than other debt issuers, such as corporations, for a given level of risk and length of maturity. However, if marginal tax rates on other debt falls, the value of this exemption also falls. Assuming there is one market for borrowing, a lower subsidy for state and local debt would translate into higher borrowing costs for state and local governments.

Business Provisions

The framework includes the following business income tax provisions:

- Reduce the maximum tax rate on income from pass-through businesses to 25 percent.
- Reduce the corporate income tax rate to 20 percent and repeal the corporate alternative minimum tax.
- Allow full expensing for new investments in depreciable property other than structures for at least five years.
- Partially limit the ability of corporations to deduct net interest.
- Repeal the domestic production activities deduction (Section 199) and some business credits other than the research and experimentation and low-income housing credits.
- Repeal other business-related special exclusions and deductions.
- Adopt a territorial system of taxing foreign-source income with provisions to limit avoidance and impose a one-time tax on unrepatriated foreign earnings.

In total, these changes would cost $2.6 trillion over 10 years. Like individual income taxes, most states use federal definitions of income to calculate state corporate income, making it much easier for them to administer a complex tax. Currently, 44 states levy a corporate income tax, but it only provides 2 percent of state general revenue.

Lowering the corporate tax rate would not directly affect states, but if a lower rate encouraged more corporate investment in the US, states would see more corporate income tax revenue. However, the move toward a territorial tax system, under which US multinational corporations would pay no US taxes on their foreign income, would encourage companies to ship jobs, capital, and profits overseas. It is difficult to predict the net effect of these changes.

A more immediate issue for states would be changes to expensing and interest deductions. The ''Unified Framework'' would allow corporations and pass-through businesses to immediately deduct all investment in new equipment, rather than depreciate the cost of those investments over time. Additionally, interest deductions would be limited. However, full expensing would not necessarily be permanent, but last for ''at least five years.''

It is likely that states would treat these changes in the same way as ''bonus depreciation,'' which allowed taxpayers to immediately write-off a larger portion of

  TM-WSTR ISSN 1534-1550

investment in equipment and was originally intended to be a temporary measure. When the federal government first allowed bonus depreciation in the early 2000s, more than half of all states decoupled or did not follow the federal government's change to prevent revenue losses

If full expensing was made permanent, decoupling from federal rules would create more work for businesses, especially those that operate across multiple states, as they would need to track depreciation schedules and rules across different states, and more complexity for the states, as they would be responsible for maintaining and enforcing those rules without federal assistance. Some states might decide it would be easier to replace their current corporate income tax with a gross receipts tax, such as Ohio's commercial activity tax or Texas's franchise (or margin) tax.

One of the largest business tax changes is the proposed 25 percent maximum tax rate for pass-through business income. Although some filers likely would report their income as business-related instead of as wages to take advantage of the lower rate, this likely would not affect states unless they also adopted special rates for pass-through income.

Estate Tax Provisions

- Repeal the estate tax and generation-skipping transfer taxes.

Fourteen states and the District of Columbia currently have an estate tax, but Delaware and New Jersey will repeal their estate taxes in 2018.

If the federal estate tax is repealed, estates could no longer claim a federal deduction for state estate taxes, thus raising the cost of those state taxes. In addition, almost all states with estate taxes depend on information collected for federal estate returns to administer and enforce their taxes. In the absence of a federal estate tax, states will need to collect and audit this information themselves.

Will the Tax Debate Move to the States?

If Congress passes a major tax bill, states will see some immediate changes to their tax laws because of piggy-backing. But a successful federal effort would mostly send states new tax questions. What will they do without the SALT deduction? Will they conform to or decouple from new expensing rules? Can they keep an estate tax? Would they also cut taxes?

Then there is the possibility of federal spending cuts. The president's budget reduced spending on Medicaid, food stamps, education, infrastructure, and other programs that deliver dollars to states. Congress could use such reductions to offset their planned $1.5 trillion increase in the deficit from a tax cut. Would states raise taxes to fill the gap?

States should brace for the possibility of major tax debates within their own capitals as they watch the events in Washington unfold.