How Would Federal Tax Reform Affect the States?

by Jéanne Rauch-Zender

In this second edition of Board Briefs, board members were asked to weigh in on how they believe federal tax reform will affect the states.

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50 Directions of Tax Reform

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I like to joke with my federal colleagues that there are no fewer than 50 directions the states could take with tax reform.

While I would expect that ultimately a significant majority of states will conform to any tax reform enacted by Congress, the degree of conformity may vary widely depending on the anticipated budget impact in each state. For instance, a hypothetical state that is a heavy export base may resist any type of income exclusion for exports, if adopted. Similarly, states with capital concentrations may refuse to conform to full expensing if this is perceived as too expensive. As a result, we may see broad decoupling from such provisions despite other base-broadening measures in place. We have witnessed similar decoupling across the state landscape before, notably relative to bonus depreciation, and it is not unreasonable to expect it here. This time around, the principal business composition within the state may well become one of the policy decision drivers of the degree of acceptable conformity.

Of course, if nonconformity were to become a prevailing theme in any particular state, I could see a desire by some lawmakers to move to a gross receipts tax for apparent greater simplicity and stability. Yet the more likely path — or at least a perceived less burdensome path in the short term — may be to freeze conformity for a year or so in order to see how the federal changes shake out, during which time the necessary analysis can be conducted to determine the impact.

Well-advised state lawmakers may also spend time considering to what degree it is constitutionally permissible for a state to adopt any expense disallowance provisions based on non-U.S. activities, but it’s probably too early to speculate, and I would not expect this to take up much airtime in the debates.

I am reminded of the public comments of California tax reform activists to the Bush tax cuts in the early 2000s,1 to the effect that since the federal government was no longer collecting a “fair share” from the people, the state would be harmed, and California should increase taxes to make up for the shortfall. As possible current

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1 John M. Broder, “Budget Deficit Climbs Steeply in California,” The New York Times, Dec. 19, 2001. Comments took place at the last California Tax Policy Conference funded by the Board of Equalization and Franchise Tax Board when the California was facing a fiscal 2001-2002 budget deficit of $4 billion. By fiscal 2011-2012, that deficit was nearly $27 billion. (Historical budget data back to 2007.) California had been back “in the black” of late but the governor’s 2017-2018 proposed budget predicts a $2 billion deficit.
Evidence that states could diverge from federal action, Gov. Jerry Brown (D) pointed out in his January State of the State address that with the funding of “tens of billions of federal dollars,” California “embraced the Affordable Care Act” with resulting coverage for “over five million people.” He then vowed and encouraged other governors, and presumably lawmakers, to “do everything we can to protect the health care of our people.”

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Already in California, we can see some tension brewing between a more territorial regime desired by Congress and the administration, and an assertion of worldwide combined reporting. S.B. 567 (Sen. Ricardo Lara (D)) was recently introduced, which, among other things, would discontinue the water’s-edge election for tax years beginning on or after January 1, 2017, with existing electors unable to elect water’s edge for tax years beginning on or after January 1, 2023.

There has been some thought that repatriation (assuming an effective repatriation of cash were adopted) might lead states to up their game in terms of competing for business investment through enhanced statutory credits or incentive programs. Looking again to California, the evidence does not quite bear that out in terms of notable bills, at least not yet. S.B. 337 (Sens. Patricia Bates (R) and Janet Nguyen (R)) merely proposes special fund allocation for any influx of revenue related to repatriation. Notably S.B. 364 (Sen. John Moorlach (R)) contains skeletal language to “address comprehensive tax reform.”

While it may be somewhat early to speculate on what will be the state-by-state reaction to enacted federal tax reform, it is not too early for taxpayers to consider what may be necessitated by these changes. Some of that may involve consideration of accelerated deductions, though resources should also be directed to managing the multiple and potentially disparate necessary changes to systems and processes to deal with staggered conformity, partial conformity, and disconformity. In other words, the more things change, the more they stay the same.


3 Id. It is worth noting, however, that California lawmakers remain constrained by the requirement of a two-thirds vote of each house in order to enact a bill that increases tax for even one taxpayer. Such an environment potentially makes any California reaction to tax reform difficult, notably one that may result in an expected tax increase.
Radical Changes Behind the Blueprint

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Any discussion of federal tax reform must be speculative because one predicts what is going to happen in Washington at one’s peril. Nevertheless, SALT professionals must recognize that the federal tax landscape may change dramatically over the next year and that may have an impact on the state and local tax landscape.

Republicans have not controlled both houses of Congress and the presidency for many years, so it has been possible for them to come up with tax reform ideas without having to put them into effect. They will no longer have this luxury. This means that they will have to zero in on the actual consequences of those ideas, and we are already seeing resistance beginning to develop to some concepts that sound nice in principle but may be difficult to apply in practice. It seems likely that there will be significant cuts in corporate tax rates but, beyond that, what will happen is anybody’s guess. The states are, of course, not required to mirror federal rate changes, but changes in the federal tax base will automatically be incorporated into the laws of most states unless the states affirmatively choose to decouple from the federal changes.

President Trump would treat an investment fund promoter’s income from a carried interest as business income, not as investment income, even though it represents the promoter’s share of the fund’s investment income. The House Republican blueprint contains no such provision. If this becomes law, promoters and managers of funds that operate in states of which they are not residents may find themselves taxed on their carried interest income attributable to those states for the first time.

The blueprint and the Trump proposal would radically change the treatment of assets used in a business. The present system, under which the cost of assets is deducted over a designated period, would be replaced by a system in which the cost of assets would be immediately deductible. The states would have to decide whether to go along with such a system. States have often decoupled from federal depreciation incentives, and full expensing is a variation on the accelerated depreciation theme.

It is obvious that a full-expensing regime would require some limitation on deducting interest. Otherwise, companies could borrow money to pay for capital investments and, in effect, get a double deduction by deducting the cash paid for the investments as well as the interest on the loan. Accordingly, both the blueprint and the Trump plan provide for some limitations on the ability of businesses to deduct interest. States would have to coordinate their approach to deducting interest with their approach to expensing assets. One wonders whether state legislatures will have the sophistication to make the connection between the two provisions.

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The House Republican blueprint provides for “border adjustability,” which, in effect, will amount to a rebate of tax on products that are exported from the U.S. to another country and a tax on products that are imported. Trump has criticized this proposal as being unduly complex, and its prospects will obviously depend on Congress’s approach to trade policy in general. Here, too, the states will have to decide whether to incorporate these concepts if they become part of the federal law. This may depend, in part, on how

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4 For a more extended discussion of these issues, see Peter L. Faber, “The Impact of Federal Tax Reform on State and Local Taxation,” State Tax Notes, Feb. 20, 2017, p. 647.
they are implemented. Obviously, if they are implemented through tax deductions or additions to income, they will automatically become a part of the laws of states that conform to federal taxable income unless the states choose to decouple.

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The border adjustment proposal has proved to be one of the most controversial proposals floating around because of its complexity (for example, how does one deal with a product that is exported but that is made in part from imported components), and because it may hurt as many U.S. companies as it helps. My prediction is that it will fall by the wayside when Congress starts to focus on it, but my predictions have not always been accurate (I thought that the Atlanta Falcons would win the Super Bowl), so one should take this with more than a few grains of salt.

Tax reform can be a good thing, but it can also cause much mischief. We will see what happens this time around.

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5 My son, Tom, in a paper written when he was in third grade, described hell as “tax reforms being signed all around.” His description was later approved by a justice of the U.S. Supreme Court.
Between a Rock and a Hard Place?

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While federal tax reform is likely to affect state tax revenue, I suspect the states’ response will be cautious for numerous reasons. First, states will need to analyze the federal tax reform package in full and digest the key elements that are most likely to receive support and pass into law. To do so, states will need to model the future impact of the proposed federal tax changes, diverting time, effort, and other state resources from ongoing state budget activity and pending state legislation.

Second, for those states that have only a part-time legislature or only consider taxes on a biannual basis, a special session may need to be called to address the impact and response to federal tax reform. This may be costly and distracting, particularly if the federal tax reform package contains items for which partisan lines will be drawn.

Third, the states will have to balance their current budget needs and projects underway with the trickle down effects of federal tax reform. Changes to the federal code, which promote capital investment or the repatriation of overseas earnings, look good on their face, but come with secondary affects. Each state will need to gauge the impact to its revenue, based on its particular tax environment, industrial base, aspects of its population, etc. For select elements of federal tax reform, it may be apropos to continue conformity with the federal code. For other elements, the cost or the policy may be unpalatable. This could result in partisan bickering at the state level and affect passage of the federal package. While unlikely to be a “chicken before the egg” situation, the administration will likely lead rather than listen first (as the brief history of this administration has shown). It would behoove federal tax reformers to conduct a “listening tour” of state treasurers and budget directors before the formal rollout of the package. While some items have been on the list for decades, others will be new efforts to address modern issues, which likely have not been thoroughly vetted. Again, the state impact will need to be carefully forecasted before valuable input can be provided as to the effect on the states, and I suspect the time frame will be too compressed to permit thoughtful reflection.

Fourth, the lessons learned from the Reagan era reform were costly for the states in terms of an increase in the complexity of tax administration. The introduction of the accelerated cost recovery system (ACRS) of depreciation forced many states to decouple from these rules due to the reduction on state taxable income that ACRS had on the states. The states will again be faced with the decision of whether decoupling will be necessary to preserve the state’s fiscal health. This will require system changes, which are time-consuming and costly to implement. States may be in between a rock and a hard place in deciding to increase complexity or face a reduction in revenue. Not an enviable position.

While unlikely to be a ‘chicken before the egg’ situation, the administration will likely lead rather than listen first.

In Michigan, we have numerous expensive initiatives underway: reform municipal employee pensions, increase educational funding, replace outdated water and sewer infrastructure, and continued investment in roads. At the same time, the Republican-led House has introduced H.B. 4001 to phase out Michigan’s flat rate 4.25 percent income tax. Federal tax reform comes at an inopportune time and will be one more moving part in 2017. Never a dull day at the office!
I Say It's Spinach

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There’s an old gag that originated in a *New Yorker* cartoon in the 1920s. In it a mother tries to persuade her daughter to eat her vegetables. The mother says: “It’s broccoli, dear.” The daughter replies: “I say it’s spinach and I say the hell with it.”

That old joke still pops up occasionally. I remember it being trotted out in 1990 when President George H.W. Bush revealed that he didn’t like broccoli, a perfectly reasonable position as far as I’m concerned but one that touched off a mini-outcry of indignation.

My bet is that the states will be saying the same thing in the near future about federal tax reform. However nutritious it is (or isn’t), I suspect it will be greeted in many states by a variation on the theme of “I say it’s spinach, and I say to hell with it.”

In a recent analysis, Anne Stauffer and Mark Robyn of the Pew Charitable Trusts pointed out that 41 states and the District of Columbia have broad-based personal income taxes that tie to the federal tax code. “Changes to federal deductions and credits could directly affect state tax systems, thus affecting revenue, and could have indirect impacts such as raising states’ borrowing costs,” they wrote.⁶

The problem is not necessarily that the idea of federal reform is bad. The problem is that it’s a huge unknown that could help or hurt the states — or help some and hurt others — and it’s impossible to know for sure based on current proposals because the end result inevitably will change, possibly dramatically, as it moves through the legislative meat grinder.

Even then, the effects of federal reform might not be clear. A cottage industry for consultants grew up in the late 1980s built on the states’ utter confusion about what the Tax Reform Act of 1986 would mean for their tax systems.

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sales tax rate increase to expire. State revenue has never been the same. To compound the problem, more tax cuts were approved in 2013.

I’m not equating federal tax reform with Kansas tax reform, but I am equating the common pitfalls of tax reform regardless of who is working on it. Federal tax reform may wind up decreasing state revenue or preempting state and local tax powers. It could raise the cost of borrowing by making currently tax-exempt bond interest taxable. Even if base broadening works and state revenue is increased, that will create challenges in these politically fraught times.

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It’s not the goal of tax reform that should make the states uneasy; it’s the fact that whatever is being proposed right now may change radically and unpredictably in a final bill once Congress and the lobby start mucking around with the details. In this game, the states are mice scurrying for cover while the elephants dance.

If the states are lucky, maybe Congress and the administration will pay more attention to their concerns than state legislatures do to local governments when they decide to “fix” local taxes. Maybe I’m unduly pessimistic, but I fear state and local governments will be served a heaping helping of spinach before this is all over.
Maybe Camus Was Right

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Taxes may be as certain as death, but tax reform, most decidedly, is not. Experts tell us that the House tax reform package either will, or will not, include select provisions; may, or may not, have the necessary Senate votes; and can, or cannot, get President Trump’s support. But one thing is certain — if enacted, it will definitely spur economic growth, unless it sparks a recession. So, how will federal tax reform affect the states? The answer depends as much on one’s philosophical outlook as on one’s choice of assumptions. A cynic, for example, might observe that prior tax reform is what gave us the current system.

I’m not the first to link philosophy with tax reform — a task that’s been called Sisyphean after the story made famous by Albert Camus, the French philosopher. Sisyphus was fated to roll a giant boulder up a mountain, just to have it roll back down, day after day, year after year, for eternity. So it’s an apt analogy. Camus, however, was not a cynic. And he insisted: “One must imagine Sisyphus happy.” But in case one finds that impossible, then Camus also said this — “There is no fate that cannot be overcome by scorn.”

States are apparently fated to have their income taxes tied to federal law — a legacy of the Willis committee. So, as my friend Jim Eads puts it, “Congress is driving the car and states are in the back seat — except that it’s not a car, it’s a train — and the states are not in the backseat, they’re in the caboose.” As a result, no matter how significant the effects of proposed federal tax reform may be, they will always be overshadowed by the effects of needed reforms. No surprise, then, that states treat federal tax reform with a bit of scorn.

Take partnership taxation. Partnerships are the fastest-growing form of business and include the complex high-wealth private equity structures that are supplanting general public ownership of midsize companies. The rise of passthroughs has been directly linked to much of the rise in income inequality over the last three decades. Federal reform proposals in this area include capping interest expense deductions (relied on for leveraged asset acquisitions) and eliminating the carried interest rules (which allow equity fund managers to treat fees as capital gains). These are certainly important reforms, but I trust their potential effect on select states is obvious.

For most states, however, the potential effects of these future reforms pale in comparison with the very real and ongoing effects of inadequate past reforms — rendering it virtually impossible to audit large complicated partnerships. Nor is this a new problem. The 1982 Tax Equity and Fiscal Responsibility Act reforms were meant to address it, but soon failed. For years there have been efforts to reform the reform. Now Congress, through the 2015 Bipartisan Budget Act (BBA), has attempted to solve the problem. I say attempted because experts tell us that substantial technical corrections are still required.

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8 Id.
11 Prisinzano and Yagen, supra note 9.
that the joint committee “scored” it as generating $9.3 billion over 10 years.\textsuperscript{14} And the effect on the states should also be obvious. But that assumes, perhaps unsafely, that these reforms will eventually be implemented. The goal of the states is fairly modest — just to be able to assess any tax resulting from the federal adjustments. But experts advise that we must nevertheless wait for the IRS to issue comprehensive regulations. And even then, they caution, state conformity may pose significant difficulties.

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Tax reform — it’s enough to make one cynical. But it doesn’t have to. Recently, I talked to the primary sponsor of a state tax reform package — the minority member of that state’s taxwriting committee. I ran into him as he was standing, surrounded and answering questions, in the lobby of the state capitol. As he turned to leave, I asked him how things were going. He said his package, which he’s worked on for months, faced stiff opposition from all sides. But he was upbeat. He told me that he was especially grateful for the endorsement of specific majority leaders who, when he offered to water down the reforms to give them political cover, had responded — if you do, we’ll pull our support. At that point, I looked over his shoulder and joked that, yes, I could see everyone was “right behind him.” And we both laughed. But he also seemed genuinely happy. So, who knows, maybe Camus was right.

All Good Tax Advice Improves With Age

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First of all, will massive federal tax reform really happen? I never dreamed that President Trump would be elected as our commander-in-chief and leader of the free world, but despite all of the polls and the odds, he’s our president. I am now a believer. If Trump says there will be tax reform, I do not doubt it for a minute. That said, however, when will it happen and what will it look like? Although there are proposals floating around Congress, Trump hasn’t released his plans but he tweets that they’ll be published soon. And thereafter, those plans will have to take the form of legislation that will have to make its way through Congress before it is ready for his signature. All good tax advice improves with age, so please take the following comments for what they are — comments on the effects of something that does not currently exist.

How tax reform will affect any particular state will depend on the state. Some states, such as Nevada, South Dakota, and Wyoming, do not impose taxes based on net income, so the federal changes will probably have little or no impact on their state tax collection, but still may affect the amount of federal aid those states receive to implement federal and state programs. Other states, such as Ohio, Texas, and Washington, have opted to impose low-rate broad-based gross receipts taxes, and their state tax collection may not be materially affected, but again with the caveat that the availability of federal funding for federal and state programs will remain neutral when that federal tax reform is enacted and implemented.

Regarding the rest of the states, how the federal changes affect a particular state will depend heavily on the extent to which each state conforms to the Internal Revenue Code. Many of the remaining states conform to the current version of the code by operation of state law, some of them conform to the code in effect as of a specific updates including new federal tax reform), and yet other states pick and choose the extent to which some code provisions apply at the state level. If the federal changes are either monstrously complicated or tend to reduce federal taxable income, many of the “total” conformity states may choose to immediately “decouple” from the code or otherwise opt for their own form of tax reform (for example, abolish their tax on net income and replace it with some form of gross receipts tax). The rest of the states will have to grapple with whether and how the new federal code changes will affect their tax bases and act accordingly.

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If federal reform is limited to reducing the federal tax rates, only the very few states like Alabama, Iowa, Louisiana, and Missouri (50 percent) that still provide some deduction for federal income taxes will be directly affected. Absent other changes, those states would enjoy a windfall based on the reduced federal income tax deduction for state purposes. If a rate change is balanced with a massive expansion of the federal tax base, all states that conform to the federal tax base would enjoy windfalls based on their state tax base correspondingly increasing. If the federal tax base retracts, however, so would their conforming state tax base. To the extent that federal tax reform includes increasing the tax base by eliminating the current federal deductions for state income taxes, that will clearly end the federal subsidy for such taxes and will correspondingly increase political pressure on the states to minimize their own state income tax rates. Finally, if federal tax reform eliminates the federal estate tax, it will have the effect of eliminating all of the piggyback state estate taxes that are designed to absorb the current federal estate tax deduction (subsidy) for them.
The lack of consistency among states regarding whether and how their state tax codes conform to the code already creates headaches for multistate taxpayers (and states) that have to keep separate federal and state tax records (or audit them) to account for those differences. The potential for increased decoupling will only exacerbate compliance for both taxpayers and the states. Traditional conformity states that choose to decouple from the new federal provisions will have to start auditing items that were formerly delegated to the IRS. That is, if a state’s starting point is tied in some manner to federal taxable income, that state’s auditors accept the federal determination of federal taxable income and only have to audit state-imposed additions and subtractions and multistate apportionment/combined reporting issues, etc. Thus, if that situation changes, the compliance burden for those states will necessarily increase.

Other federal tinkering could “help” affected states but have the effect of wiping out entire industries. For instance, if Congress decides to eliminate federal tax credits, many states with piggyback credit programs would enjoy windfalls (that is, if the federal credits disappear, so will the coupled state credit programs). There would, however, be very serious repercussions for specific industries such as low-income housing development and historic restoration redevelopment contractors. Those businesses have traditionally relied heavily on monetizing the federal and state credits for financing purposes, for the past five decades. And what will happen to the public benefits those programs foster — will restoring our historic treasures now be too expensive and will it become much more difficult for low-income people to find decent and affordable places to live?

On a personal note, State Tax Notes subscribers with children still in school might want to encourage them to become state tax professionals (except for estate planning, of course). Regardless of how the states and taxpayers are affected, as long federal tax reform does occur, no matter what federal reform occurs, it will provide additional job security for all state tax professionals (except possibly for estate planners) for years to come.
The international proposals present some of the same policy issues, as well as other issues depending on what may be passed. A border adjustment incentive for exports could take the form of a deduction, which may pass through to the states and reduce income absent decoupling, or it could take the form of a credit, which may not pass through to the states. States might also need to revisit how they tax foreign operations and dividends, and adjust to federal law changes.

There are other proposals in Washington that are not labeled as federal tax reform but may affect state tax policy indirectly. Changes to the Affordable Care Act might shift some costs from the federal government to the states, adding further strain on state budgets and affect state tax policy decisions. That shifting of costs could be true in other areas of the federal government as well given the focus on deregulation, such as with environmental policies. Of course, if deregulation leads to increased profitability (such as for financial institutions), that may in turn increase state tax revenue. However, the freeze on regulations in some cases, such as with the new federal partnership audit regulations, creates uncertainty for the states and for taxpayers.

Aside from major federal income tax reform, efforts are still being made to encourage Congress to act on the remote seller sales tax nexus issues (Main Street Fairness-type initiatives), as well as to consider safe harbors for state income tax and withholding tax nexus (BATSA-type initiatives). There is much speculation as to the likelihood of any action on these types of proposals, and it is probably fair to say that these concerns do not appear to be a current priority in Washington. However, that could change and the passage of any of these proposals could greatly affect the states.
One final note that appears outside the current playbook is that from time to time there is talk of replacing our federal income tax with a form of a consumption tax, possibly like the value added tax. It remains to be seen if that concept will be introduced in this process, as predictability does not appear to be the hallmark of today’s political environment. A change of that nature could have tremendous state tax implications.

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The proverbial devil will be in the details of any tax reform, and those details are not yet known. Nevertheless, it is critically important for businesses and states alike to prepare to react to these changes notwithstanding the multiple possibilities, uncertainty, and lack of detail. Any changes need to be considered at the state level both individually and collectively. This will be a complex form of three dimensional chess.

One outcome of major federal reform seems certain. States will need to react and they will react differently, and those divergent reactions will result in a multitude of disputes with taxpayers.
Monitoring the Unknown

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Attempting to identify likely state and local tax effects of federal tax reform is, obviously, very difficult when the nature and extent of federal tax reform is unknown. However, in today’s dramatically unique and volatile political environment, attempting to do so isn’t difficult, it is almost impossible. Nevertheless, we can give it our best shot.

Increasing State Revenue

One amendment to the Internal Revenue Code that has been the subject of much press, both general and tax-technical, would eliminate the itemized deduction for state and local income taxes. I recall attending a Senate Finance hearing a few years ago during which virtually every senator who spoke questioned why the federal government has been so “generous” to give the states the “gift” of this federal deduction. If, in fact, such an amendment is enacted, and the economic burden on individuals who pay state and local income taxes is thus increased, one can expect greater pressure to be placed on state legislatures to reduce income tax rates (“greater” since income taxes are already known as one of two most disliked taxes, the other being ad valorem property taxes). State governments, however, will want to maintain or increase tax revenue since this seems to be a natural tendency, which would only be exacerbated if the federal government were to shift financial responsibility for more programs from the federal government to the states. What is the most likely source for this additional tax revenue?

Although some politicians seem to believe that they can get away with being both anti-business and pro-jobs, there is not much fertile ground left in the corporate income tax (or other direct/business activity tax) area. Through economic nexus and single sales factor with market-based sourcing, the economic burden has already been shifted from a state’s resident business to those outside the state’s borders. The unpopularity of ad valorem property taxes and their usual dedication to local governments means that such taxes are unlikely targets for generating greater revenue. That leaves sales and use taxes as the likely target.

It is very reasonable to expect efforts to be mounted to broaden the sales tax base to include sales and purchases of digital goods and more services. While there are respectable arguments to support such expansion, the fundamental principle in a consumption tax, such as the sales tax, is that business inputs not be taxed will get lost in the debate, as it has been for quite a while. Since the sales tax is one of the least disliked taxes, such expansion may occur, but one can still hope that it will be done in a way that minimizes state-to-state inconsistencies.

Decoupling

If the code is amended to alter the way capital acquisitions are treated in computing net income (for example, immediate expensing, short depreciation schedules, credits rather than deductions), some states will surely decouple from such provisions. Such decoupling has historically been based on a state’s revenue needs rather than on a careful investigation and consideration of (1) whether the economic policy of a state is really that different from the economic policy of the country as a whole, and (2) whether decoupling has any economic development effect on a state’s economy, especially in light of the corporate income tax burden having been largely shifted outside the state, as noted above. While state officials have traditionally lobbied the congressional taxwriting committees in attempts to minimize negative state revenue effects of federal tax changes, members have traditionally not been substantially swayed.

Other Changes

There has also been quite a bit of chatter about major changes being made to the federal gift and estate taxes. While such changes might have a major impact only on a handful of states, it is important for state tax practitioners to monitor this area carefully. Of course, other possible changes, such as increased import duties and Mexico border wall tolls might cause radical changes in the nation’s economy, and thus the economies of the states, so everything we now know about state taxes may no longer be valid (perhaps Al Yankovic said that better).
Trump Tax Reform Effect on States

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What does it all mean in our world of SALT? One rule of predictions: Prognosticating can be a dangerous business — just ask the handler of Punxsutawney Phil about each time Phil is suddenly awakened on February 2 to make his weather prediction. These guys wear gloves, and not just because it’s cold outside. Predictions of the Trump Effect may be similar in consequence.

Let’s start with the basics. Trump wants to get America back to working. Translation: new jobs, all of which by definition will be at the local level. The Trump Effect: increased state and local payroll taxes, increased contributions to state unemployment funds, which are still near depletion in some areas of the country, and increased dollars circulating in the local economies. Using a standard 2.5 economic impact multiplier for every new dollar in a local economy, one can begin to see the Trump Effect, and can begin to quantify it.

Next, let’s talk about repatriation of foreign-based earnings held by U.S. nationals. Absent increased stock repurchase plans and extraordinary dividend payments, and coupled with continued relatively lower interest rates, these funds will likely be put to work through capital expenditures or plant and new job expansion. The Trump Effect: increased physical presence in local communities through deployed capital will lead to an ever-increasing share of business taxes through expanded operations, yielding increased apportionment numbers and local jobs created through construction and installation, all of which means more state and local tax revenue as a result.

And what of Trump’s desire to significantly accelerate federal income tax depreciation or increase annual cost expensing dollar caps? The repatriation discussed above leading to increased capital expenditure will lead to even more capital expenditure if cost recovery is significantly accelerated at the federal level. The Trump Effect on the state and local side: More states will not adopt the federal changes, will keep in place their current depreciation or expensing provisions, or will decouple from linking to the federal rules when presented with this situation.

What about the Trump import and export policy? A touchy area and one yet to be fully fleshed out by the Trump administration, it could lead to diminished exports, which would lead to a negative impact on those parts of the country that have export-heavy businesses such as manufacturing and production, significant agricultural products, and more. The Trump Effect: possibly a slowdown of production in those areas, causing a loss of state and local tax revenue calculated considering the above form of analysis.

Finally, Trump’s anti-regulatory, pro-business approach on government intrusion may well slow down federal legislation designed to preempt state and local tax or conform SALT taxing jurisdiction across the country. But with the massive federal tax reform-related changes he is proposing in such an immediate and compressed time frame, it is certain that Congress will require concessions in order to facilitate and secure various constituencies’ support. The Trump Effect: Some of the federal pieces of legislation that we have seen in D.C. over the last five years may very well make it, not so much on their merits, but rather being part of the price of the deal needed for Trump to get what he wants.
Untangling the State and Local Implications of Trump’s Tax Plan

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The potential for federal tax reform in the next year or two is real — although there is not yet a full tax bill ready for debate. The type of tax reform that President Trump presented as a candidate in November aimed to: reduce the corporate income tax rate and allow expensing for select types of business investment; flatten the individual income tax rate structure; and simplify income taxes by increasing the standard deduction and eliminating a host of itemized deductions. A tax plan of this flavor has numerous implications for state and local taxes — but these are not easily untangled. It is therefore, perhaps, unfair to highlight how one item from potential tax reform can affect state and local governments, but this note does just that by looking at the implications of eliminating the state and local tax deduction.

Consider this one of many building blocks toward understanding the big picture of tax reform and the future for intergovernmental fiscal relations.

Currently, taxpayers who itemize their federal return may take a deduction for state and local property taxes, state and local income taxes, or sales tax paid. For each dollar of these state and local taxes paid, the itemizing taxpayer deducts $1 from federal taxable income. This reduces the taxpayer’s federal liability by $1 times their marginal tax rate. At a 28 percent tax rate, a $1 deduction reduces federal taxes by $0.28. The deduction effectively reduces the cost or price of state and local taxes by 28 percent in this example with the feds subsidizing state and local governments by picking up part of the tab. Nationally, the deduction for state and local income tax comes with a large price tag — $84.4 billion (fiscal 2017) in terms of forgone federal income tax revenue.15

In 2014, 28.5 percent of taxpayers itemized their tax returns.16 Taxpayers with adjusted gross income greater than $100,000 accounted for 45 percent of returns claiming the state and local tax deduction and 82 percent of the state and local tax deduction actually claimed. Elimination of this particular itemized deduction will have its greatest impact on taxpayers in the higher income groups. And not all states are equal in terms of their use of these deductible taxes. States with heavier reliance on individual income and sales taxes face a larger increase in their price for public goods. For example, on average, states receive 29 percent of their general revenue from sales and individual income taxes. Connecticut, Minnesota, and Hawaii bring in more than 40 percent of their general revenue from these taxes and 14 additional states bring in at least one third of their general revenue from these taxes.

A tax plan of this flavor has numerous implications for state and local taxes — but these are not easily untangled.

How would state and local governments be affected and react to this type of change? Let’s abstract from other federal tax changes, which together, have a net impact on consumer and producer behavior, levels of output and prices, and reactions of state and local governments. Loss of the state and local tax deduction hits taxpayers’ wallets — the price of state and local public goods increase if the deduction is lost. Generally, when prices go up, demand goes down. For state and local governments, would there be a call by taxpayers to reduce spending to keep their net tax

15 “Tax Expenditures,” including “Non-business state and local taxes other than on owner-occupied homes” plus “state and local property tax on own-occupied homes.”
16 IRS, Statistics of Income, “Tax Stats.”
bill unchanged? Can state and local governments effectively reduce the level of public spending to accommodate the increase in net cost to the taxpayers?

For state and local governments, would there be a call by taxpayers to reduce spending to keep their net tax bill unchanged?

The implications of a loss in the state and local tax deduction are complicated by other possibilities for federal tax reform. If, for example, the feds reduced overall taxes, would taxpayers critically separate their net federal tax bill from their net state and local tax bill and react separately to the increased net state and local tax bill? The evidence from prior reforms is mixed, again complicated by other changes in the tax system. There is increasing evidence that tax changes need to be salient for individuals to react. If taxpayers do not see and feel a tax change, they do not necessarily react to the change as traditional theory would predict. Whether an increase in state and local tax price due to a loss in federal deductibility is large and transparent enough to be salient to taxpayers is an empirical question not yet answered. No matter the net impact, it is important to recognize the inherent partnership of tax policy in the U.S. — intergovernmental impacts of federal tax changes are an important consideration in the debate.


The Devil Is in the Details

Marilyn A. Wethekam is a partner with Horwood Marcus & Berk, co-chairing the firm’s multistate state and local tax practice. The devil is in the details and currently the federal tax reform proposals are more theoretical than detailed. However, the common theme of the proposals seems to be territorial, taxing imports, encouraging repatriation of foreign earnings by reducing the rate of tax on those earnings, and stimulating the expansion of domestic manufacturing by expensing cost recovery. The proposals would cut the corporate tax rate to compensate for the expansion of the federal tax base.

Most states conform to federal taxable income and use it as the starting point for the calculation of taxable business income subject to apportionment. The manner in which the states conform generally take one of three basic approaches:

- piggyback the Internal Revenue Code;
- take a static approach and adopt the code as of a specific date; or
- adopt only specific provisions of the code.

The fundamental question is will the states adopt some or all of the proposed changes, or decouple from the changes as numerous states have done in the past? In either instance, a state legislative effort is likely to be required, which will allow local interests to potentially influence the ultimate outcome. What may prove beneficial for federal tax purposes may not be beneficial at the state level.

The federal proposals broaden the tax base but then offset some of the impact of that broader base with a reduction in the corporate rates. At the state level, the starting point in most cases would be the broader tax base but there is no link between the state corporate tax rate and the federal rate. As a result, the states have the potential for a windfall without a real incentive to reduce the state corporate rate. That windfall may be partially mitigated by some unique state tax issues resulting from the proposals. Drilling down into some of the actual proposals gives rise to numerous issues at the state level that may not have a federal counterpart. For example, will the repatriation of foreign earnings be characterized as dividends? At the federal level, only in very limited circumstances would the funds qualify for a dividends received deduction. The various federal proposals would tax this income at a significantly lower rate. The states, however, are required to treat foreign and domestic dividends the same. The repatriated funds, if characterized as a dividend, should be subject to the state dividends received deduction. The repatriation issue becomes more complex in those states that allow or require a worldwide combined return. To the extent the earnings of the foreign entity have been included in the worldwide return, those earnings have been included in taxable income and taxed in a prior year. As a result, a specific subtraction modification may be required to avoid the potential for double taxation. Another example of the complexity that may result from federal tax reform is the fact that at the federal level there is no characterization of income. However, for state corporate income tax purposes, it must be determined if the income is apportionable business income or allocable nonbusiness income, thus increasing or decreasing the state tax base. The characterization of the income may not only affect the computation of the state tax base but also may affect the computation of the formula used to apportion that tax base as well.

The destination-based cash flow tax (for example, border adjustment) raises some interesting issues with respect to the impact on existing tax treaties, World Trade Organization requirements, and the economic viability of a tax structure that picks winners and losers. While the mechanism for implementing this type of tax structure has not been defined, it appears to place a significantly higher tax on products, services, and intangibles that are brought into the U.S. regardless of where they are manufactured. From a state tax perspective, how would this border tax adjustment be classified? Is this a tax that is imposed or measured by net income? Most states deny a deduction for income taxes. However, if structured as an indirect tax that is imposed for the privilege of importing goods, services, or intangibles, it may be deductible for state purposes. Yes, the devil is in the details.
Federal Tax Reform — Consider the States

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Everyone is anxiously awaiting tax reform legislation — including state officials. On February 14 California Assembly Revenue and Taxation Committee Chair Sebastian Ridley-Thomas (D) hosted a town hall on the impact of federal tax reform on California. All of the participants seemed to agree that the fiscal impact on the state’s budget would be the key consideration regarding how lawmakers will react to tax reform. California does not automatically follow federal law on tax, although it is generally agreed that keeping California’s tax laws somewhat in sync with federal law facilitates compliance and tax return preparation. California conforms to the Internal Revenue Code as of January 1, 2015 (but has been known to let conformity legislation languish for six or seven years before the state catches up with federal changes).

At the moment, California’s fiscal outlook seems to be stable, but Democratic Gov. Jerry Brown’s budget (unveiled January 10) was premised on the fact that revenue growth is declining with the possibility of a more than $1 billion deficit if the current budget continues into the next fiscal year. Therefore, the governor’s proposed budget limits expense increases in the next fiscal year. So far, in the first seven months of the fiscal year that began in July, total revenue of $66.76 billion is $392.5 million below last summer’s budget estimates and $115.5 million short of January’s revised fiscal year-to-date projections. So, the governor’s cautious approach might be the best way to address tax reform.

So far, what we know about tax reform is that it is a high priority for the Trump administration. There is a brief outline of President Trump’s proposed changes and a more detailed House of Representatives Tax Reform Plan (a part of their “Better Way” plan for the country). The question is how many of those changes the states will be able to afford in light of potential cuts in federal funding for other programs (such as the Affordable Care Act subsidies).

The balance of this article looks at selected provisions from Trump’s and the House of Representatives’ tax plan and discusses how California might view the change.

Individual Provisions

Individual Tax Rates

Both the Trump and House plans replace the individual tax brackets with three tax brackets and lower the maximum rate from 39.6 percent to 33 percent.

California has its own rate structure and in fact just raised rates through the passage of Proposition 55 in the November election, which extended the temporary tax increase through 2030 (the rate increase was scheduled to expire in 2018). Because that was done by proposition (a vote of the people), it makes it much more difficult to repeal that action by legislation.

Capital Gains

The Trump plan would keep the maximum capital gain rate of 20 percent, but would establish new tax brackets. The House plan appears to eliminate the capital gains rates and substitutes a 50 percent exclusion from gross income of net capital gain, dividends, and interest income.

California does not provide for a tax preference for capital gains, so it appears unlikely that the state would adopt whichever option is finally enacted into law.

Personal and Dependent Exemptions

Both the Trump and House plans eliminate these exemptions and replace them with a much higher standard deduction. California’s personal and dependency exemption is claimed as a credit. It could be repealed if California decided to pick up the higher standard deduction.

Standard Deduction

Both the Trump and House plans significantly increase the standard deduction (the Trump plan would allow $30,000 on a married filing jointly
return, and the House plan would allow $24,000. California has its own standard deduction but might conform if the numbers showed that the repeal of the personal/dependency exemption provided a sufficient revenue increase to offset the increased standard deduction.

**Alternative Minimum Tax**

Both the Trump and House plans eliminate the individual alternative minimum tax. California has the AMT, but it does not affect nearly as many taxpayers on the state side as it does on the federal side. There are three primary reasons for that result. The first is that the state does not allow a state income tax deduction on the regular tax return. That is a big federal deduction for taxpayers who itemize and file in high tax states. It is reversed for AMT purposes, with the result being that many middle-income taxpayers fall into AMT at the federal level (but not the state level). Furthermore, California’s AMT rate is 7 percent — significantly less than the marginal rate for many middle-income taxpayers who pay a regular tax which approximates 9.3 percent. That is not the case for federal purposes, where the marginal AMT rate is 28 percent, approximately the same marginal rate that applies for regular tax purposes. Also, California has always adjusted the AMT exemption for inflation. Federal law was recently amended to adjust the federal exemption for inflation, but for many years the exemption was set by statute and did not change. The simplification that comes with repeal might gain so much taxpayer support that California would have difficulty justifying retention of the unpopular tax.

**Itemized Deductions**

The Trump plan favors retention of all current deductions but would cap the deductions at $200,000 for married filing jointly (and $100,000 for single). The House plan would eliminate all deductions except mortgage interest and charitable contributions.

The Trump plan could be of interest to California lawmakers. The House plan will not fare so favorably in California, as it knocks out the state income tax deduction on the federal return. That would have a significant impact on many taxpayer returns as California has the highest income tax rates in the nation.

**Filing Status**

The Trump plan eliminates the head-of-household filing status, while the House plan creates a new status for a single person with a child in the household.

In a blue state (such as California), repeal of a provision that indirectly provides benefits to single moms is not going to be popular. I do not think legislation like that could get through the Democratic Legislature.

**Business Provisions**

**Tax Rates**

The Trump plan wants to lower the corporate tax rate to 15 percent, while the House plan wants to lower it to 20 percent.

California has had a flat corporate tax rate of 8.84 percent for many years. I don’t think California is likely to change.

**Tax Rates for Schedule C Filers and Flow-Through Entities**

The Trump plan proposes a 15 percent rate on flow-through entities and sole proprietors. The House plan calls for a 25 percent maximum rate, but emphasizes that flow-through entities and sole proprietors must pay reasonable compensation.

California already has an elaborate tax scheme in place for flow-through entities (and as most readers know, it is quite different for S corporations, limited liability companies, and limited partnerships). California does not tax general partnerships or sole proprietors and might find the federal plan appealing if it provides increased revenue and the state continues to experience declining revenue growth.

**Depreciation**

The Trump plan proposes increasing the IRC section 179 deduction to $1 million and would allow manufacturers to elect to expense 100 percent of equipment purchases. The House plan would allow 100 percent expensing of all tangible and intangible property purchases.
California has not historically followed federal law in this area. California never conformed to bonus depreciation or to the increased IRC section 179 election (retaining the $25,000 deduction capped at expenditures of $200,000). Those provisions were just too expensive for the state to incorporate in its budget. The outlook for conformity here is probably not good.

Interest Expense

Both the Trump and House plans limit the deduction for interest expense as a trade-off for the generous write-off for tangible property purchases discussed above. The Trump plan would not allow any deduction for interest for manufacturers that elect 100 percent expensing, and the House plan would only allow deduction for interest up to the amount of interest income.

California would probably not conform to those provisions if the state does not conform to the enhanced write-off discussed under depreciation.

Repatriation of Corporate Profits

The Trump plan proposes to drop the tax rate to 10 percent if profits are repatriated back to the U.S. The House plan has no similar provision.

California’s tax system is fundamentally different from the federal system in that California uses worldwide combined reporting for the worldwide unitary group. So, foreign earnings apportioned to California have already been taxed by the state when earned. In general, dividends paid by a member of the unitary group are eliminated in the combined report.

Conclusion

Conformity to federal law simplifies the tax return preparation process, and that is always a consideration. However, California legislation is largely driven by the state of the economy. If the state does experience declining revenue growth, whatever stimulus package is enacted at the federal level may not be of much interest to the state. If it appears that the state is descending into a recession, tax reform takes a back seat to all of the other demands on the state’s limited resources.