What Could Federal Tax Reform Mean for the States?

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Federal Tax Reform: 2017 Timeline

- **June 24, 2016** - House Republicans released their vision for tax reform (the Blueprint).
- **April 26, 2017** - President Trump released his overall vision for business tax reform.
- **Nov. 9, 2017** - The Senate released its federal tax reform proposal.
- **Nov. 16, 2017** - The House passed its tax reform bill 227-205
- **Dec. 2, 2017** - The Senate passed its tax reform bill 51-29
- **Next Steps** - Conference, House and Senate to vote on final legislation.
Overview of Tax Reform in Congress

• House and Senate have each passed $1.5 trillion tax cut bills that overlap in many respects
• Differences to be resolved in conference: final bill likely to be closer to Senate version
Debt Held by the Public as Percentage of GDP Under Alternative Scenarios, 1790-2047

Source: CBO Long-Term Budget Outlook, 2017.
US Top Marginal Corporate Tax Rate Compared to the Rest of the World

Worldwide Taxation
Territorial Taxation
Why Tax Reform?

- One of the highest corporate income taxes in the world (profit shifting).
- High effective rate too, varying by industry.
- International system encourages inversions.
- Debt-equity bias: debt is favored in corporate tax code.
Why Tax Reform?

- Not one, but two business tax systems.
- “Pass-through businesses taxed on owners individual tax returns at ordinary rates.
- No “double tax.”
- Number and significance of pass-through businesses has grown over the past 30 years.
Why the Majority of Income is Tax-Free
Calendar Year 2006

- Unreported Income: 10.8%
- Untaxed Transfers: 8.3%
- Employee Benefits: 8.2%
- AGI of Nonfilers: 4.4%
- Other Net Exclusions: 5.6%
- Itemized Deductions: 9.3%
- Standard Deductions: 3.4%
- Exemptions: 5.8%
- Tax Credits: 5.0%
- Taxable Income: 39.2%

Source: Tax Foundation calculations based on data from the Internal Revenue Service and the Department of Commerce’s Bureau of Economic Analysis
But US Overall Tax Burden is Modest by International Standards
Tax as Percentage of GDP, 2017

Source: OECD, tax statistics, 2017
<table>
<thead>
<tr>
<th>Provision</th>
<th>House TCJA</th>
<th>Senate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indiv. Rates &amp; Brackets</td>
<td>Four, top 39.6% + bubble</td>
<td>Seven, top 38.5%</td>
</tr>
<tr>
<td>Deductions &amp; Exemptions</td>
<td>Standard $12,200</td>
<td>Standard $12,000</td>
</tr>
<tr>
<td></td>
<td>Cap SALT $10,000</td>
<td>Cap SALT $10,000 property</td>
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<tr>
<td></td>
<td>Limit MID $500,000 1st</td>
<td>MID end equity debt ded</td>
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<tr>
<td>Credits</td>
<td>Child credit $1,600, phaseout above $230,000</td>
<td>Child credit $1,650, phaseout above</td>
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<td></td>
<td>$300 family credit</td>
<td>above $1m</td>
</tr>
<tr>
<td>Pass-throughs</td>
<td>25% rate cap with 70-30 anti-abuse rule</td>
<td>23% deduction, 50% wage cap, income cap, service exclusion</td>
</tr>
<tr>
<td>Corporate Rate</td>
<td>20%, effective 2018</td>
<td>20%, effective 2019</td>
</tr>
<tr>
<td>Capital Investment</td>
<td>Increases 179 cap to $5m, phaseout at $20m</td>
<td>Increases 179 cap to $1m, phaseout</td>
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<tr>
<td></td>
<td>Caps interest ded at 30%</td>
<td>phaseout at $2.5m</td>
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<td>Caps interest ded at 30%</td>
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<tr>
<td>NOLs</td>
<td>Eliminates carrybacks, allows 90% carryforwards with inflation adjustment</td>
<td>Eliminates carrybacks, allows 90% carryforwards which drop to 80% in 2023</td>
</tr>
<tr>
<td>International Tax</td>
<td>Territorial w anti-abuse excise tax; 14%/7% deemed repat</td>
<td>Territorial w/ anti-abuse min tax; 14%/7% deemed repat</td>
</tr>
<tr>
<td>Estate Tax</td>
<td>Repeal after six years</td>
<td>Double exemption</td>
</tr>
</tbody>
</table>
Business Tax Reform Proposals

• Business Tax
  • Corporate rate reduced from 35% to 20% (Senate: Delay one year to 2019 tax year)
  • Immediate expensing of business investments in certain new and used assets for five years (JCT: -$84B first five years)
  • Limit net interest deductions to 30 percent of ATI (essentially EBITDA) – (JCT: +$172B)
    • Senate: similar provision (+$308B)
  • Limit NOL deduction to 90 percent of ATI: eliminate carrybacks; unlimited carryforward (with interest)
  • Repeal/restrict special exclusions or deduction (e.g., IRC § 199 domestic manufacturing deduction) (JCT: +$95B)
    • Senate maintains AMT

• Pass-Through Businesses
  • 25% capped tax rate; 70% safe harbor for wage income. (JCT: -$448B); 9% rate for some passthrough income
    • Senate: no rate cap but 17.4% deduction for pass-through income
Key Business Provisions – Senate Bill

- Cut corporate tax rate to 20% (23% individual income tax deduction for unincorporated businesses)
- Businesses may immediately deduct (expense) new equipment investment; interest deduction limited
- Tax on accumulated foreign earnings, followed by exemption of foreign profits from US tax (territorial tax system); porous anti-abuse measures
- Retains corporate AMT (also at 20% rate)
- Individual provisions except chained CPI, expensing repealed after 2025
International Tax Reform Proposals

• Move from worldwide to territorial tax system
  • 100% exemption for dividends from foreign subsidiaries (at least 10% owned)
  • Accumulated foreign earnings held overseas treated as repatriated under special Subpart F classification, with a bifurcated rate (14%/7%) for liquid and illiquid assets (JCT:+$293B) (Senate: 10%/5% rates)
• Current year inclusion of income with “foreign high returns” (JCT:+$77B)
• Excise tax on outbound related party payments; ECI election (+154B)
• Require some R&D expenditures to be capitalized over 15 years for research conducted outside the country (+$70B)
• Senate: Has its own base erosion measures ($123B) and a current-year inclusion for global intangible low-taxed income ($115B).
Individual Income Tax Proposals

• Reduce 7 tax brackets to 4 tax brackets – 12%, 25%, 35% & 39.6%  (Senate: keeps 7 tax brackets)
• House eliminates AMT (Senate raises income it takes effect)
• Increase standard deduction (approx. double), while eliminating personal exemptions
• Eliminate most itemized deductions including deduction for state income (and sales) taxes
  • House modifies home mortgage interest deduction for newly purchased homes (capped at $500k of value; grandfather for existing mortgages);
  • Both limit property tax deduction to $10,000 (but not foreign);
  • Retain charitable deduction (JCT:+$1.26T)
  • Number itemizing falls by ¾; even if SALT maintained would fall by half
• Eliminate estate tax  (Senate keeps estate tax but increases size of estates that qualify for exemption)
Key Individual Features—Senate Bill

- Top individual income tax bracket cut from 39.6% to 38.5%
- Nearly double standard deduction (to $24,000 for couples)
- Repeal personal exemptions; double child tax credit (partially refundable); nonrefundable credit for nonchild dependents
- Repeal state and local income tax deduction; limit property tax to $10k
- Higher threshold for AMT
- Index tax brackets, credits by chained CPI
- Double estate tax exemption (to $22 million for couple)
- Repeal ACA individual mandate penalty
FIGURE 1
Change in after-tax income under TCJA
As passed by the House for 2018, and by the Senate for 2019

FIGURE 2
Change in after-tax income under TCJA
As passed by the House and Senate, 2027

Percent

3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5

Lowest Quintile  Second Quintile  Middle Quintile  Fourth Quintile  Top Quintile  All  80-90  90-95  95-99  Top 1 Percent  Top 0.1 Percent

House 27  Senate 27

How Will Tax Reform Impact the States?
State Revenue Sources

• Individual Income Taxes = 36% of State Raised Revenue
• General Gross Receipt/Sales Taxes = 31.3% of State Raised Revenue
• Selective Sales Taxes = 16.2% of State Raised Revenues
• Corporate Income Taxes - Levied in 44 states; account for just 5.4% of state tax collections and 2.7% of state general revenue.
• Composition varies across states based on tax instruments and economic base
State Revenue Changes Over Time

Sources as Percentage of General Revenue

Source: Census.
Note: Percentages do not add to 100% because some sources are omitted.
### State Conformity to Federal Tax Law

<table>
<thead>
<tr>
<th>Federal</th>
<th>States</th>
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<tbody>
<tr>
<td>Broadened tax base and lowered tax rate (inc. SALT)</td>
<td>States generally conform to base but not rates</td>
</tr>
<tr>
<td>Standard deduction &amp; personal exemptions</td>
<td>Bills roughly double former and eliminate latter; should analyze net impact of this + child credit</td>
</tr>
<tr>
<td>Special pass through entity rate (Senate 23% deduction)</td>
<td>Senate version picked up by states that conform. Potentially significant revenue loss.</td>
</tr>
<tr>
<td>Net Operating Loss carryback repeal, carryforward cap</td>
<td>Many states conform or at least shadow fed limits</td>
</tr>
<tr>
<td>Fully expensing &amp; limited interest deductibility</td>
<td>State partial conformity; analyze impact together</td>
</tr>
<tr>
<td>Deemed repatriation (14% cash/7% structures)</td>
<td>One-time windfall for states coupling to Subpart F</td>
</tr>
<tr>
<td>Territorial, including tax on high return foreign income and other base erosion measures</td>
<td>State partial conformity</td>
</tr>
<tr>
<td>Estate tax: House eliminates, Senate doubles exemption</td>
<td>If House, keep or eliminate. If Senate, conform?</td>
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What Happens Next?

- House and Senate Votes and Conference Committee deliberations.
- Will tax rate cuts and/or deductions be limited to 10 years to satisfy requirements of the Senate Reconciliation process?
- Some provisions expire before hand and assumption will be extended
- Will some of the pay-fors be changed?
  - Fate of the state and local income and property tax deduction?
  - Change in tax rate on repatriated income and other provisions taxing foreign income or outbound related-party payments?
  - Limitation on interest deductions?
- Generally effective for tax years beginning after 2017.
- Will federal tax reform survive the slim margin of error created by the narrow Republican majorities in the House and Senate?