Federal tax reform spurs tax cuts

David M. Kall | Thursday, May 10, 2018

In a number of our recent articles, we have addressed various states' responses to the changes in federal tax law brought about by the late 2017 Tax Cuts and Jobs Act. A report by the Council On State Taxation and State Tax Research Institute predicts that the act "will result in corporate income tax reductions over the first 10 years of $329.4 billion, [which is a] reduction of about 10 percent year in corporate income taxes at the federal level."

At the state level, the report recognizes that the act is expected to generate revenue increases, because states generally conform to many of the federal provisions that increase tax revenue. The increase in individual states is projected to range from about 7 percent to 14 percent, for an aggregate rate of about 12 percent, in the first 10 years.

Responses to federal tax reform

Thus, conformity is one of the key areas of the act's impact. The Tax Foundation explains that "[s]ome states adopt large swaths of the federal tax code by reference; others use it as a starting point, then tinker endlessly; and still others incorporate federal provisions and definitions more sparingly."

Currently, the group observes, 18 states and the District Columbia have rolling conformity with the Internal Revenue Code; these states will automatically conform to relevant provisions of the new federal law. Nineteen must actively take steps to update their fixed-date conformity statutes, while the remaining states only conform selectively. This leaves many states at risk for not maximizing the act's benefits; one

new provision, for instance, permits the immediate expensing of investments in machinery and equipment, "an important pro-growth element of federal tax reform."

States have their own justifications for their conformity choices. While coordination with federal tax laws means giving up some control, there are benefits. These include reductions in compliance burdens; resource-saving "reliance on federal statutes, rulings, and interpretations, which are generally more detailed and extensive than what any individual state could produce;" and simplification for taxpayers, who can copy portions of their federal returns into their state documents.

Georgia's new tax cut plan

A number of states, like Georgia, have taken advantage of the act's expected revenue increases to cut their own tax rates. Some frown upon this strategy, like the Institute on Taxation and Economic Policy (ITEP), which characterizes it as "taking bad federal ideas and running with them."

In Georgia, ITEP notes that "the state's peculiar relationship to the federal tax code means [that the Act] could [have generated] more than $1 billion of state revenue, which could have been devoted to improving the tax code, preparing for federal funding cuts to come, and/or restoring full funding to K-12 schools; instead, lawmakers have passed a bill focused on cutting the top income tax rate and ultimately *reducing* the funding available for these priorities." The Tax Foundation estimates a windfall of $5.2 billion over five years.

The bill at issue is HB 918, which the governor signed into law in early March. Among other things, the measure lowers the tax rate for corporations from 6 percent to 5.75 percent, and for individuals, from 5.75 to 5.5 percent, for tax years starting with 2019.

Georgia Budget & Policy Institute responded like ITEP did, asking whether lawmakers would come to regret their "risky tax plan." HB 918 would generate $1.4 billion in annual losses for the Peach State once fully phased in. While superficially appealing, this could prove to be "penny wise and pound foolish… [because] Georgia's fiscal future faces an unusually high degree of uncertainty. Eventual revenue collections might fall short of preliminary projections, due to the high level of complexity caused by the federal tax changes enacted in December. An economic recession might lurk around the corner. And Congress is reportedly considering sweeping budget cuts to key services such as Medicaid and food assistance that hold potential to shift large new costs to state taxpayers. Reducing income tax rates also tends to become more burdensome in the long-run than expected, as states like Kansas and Louisiana found out the hard way."

On the other hand, the Tax Foundation lauded on the deal. Despite the estimated five-year projected loss of $5.7 billion that the state tax cuts would generate, the group noted that surrounding jurisdictions, like Florida, Tennessee, North Carolina and Alabama all have more favorable tax rates. In addition, the individual rate reduction, "combined with the doubling of the standard deduction, will likely lower tax bills for most taxpayers in the state." Lower rates benefit business too, relative to the surrounding states' competitive corporate tax rates.

ITEP noted that Idaho, Iowa, and Missouri are also considering regressive tax cuts, arguably to their own detriment.

Other reactions

Beyond tackling these kinds of matters, states' reactions to the Tax Cuts and Jobs Act are all over the

board. The ITEP article referenced above describes various trends that emerged during the first quarter:

- Crafting new policies that “offset rather than exacerbate” certain of the Act’s “regressive and/or budget-busting effects.” Examples include surcharges on corporate profits above a certain level in California, and millionaire’s taxes in New York, New Jersey, and Nebraska. Such a law in Nebraska is not likely to pass.
- Preserving personal exemptions, as in Maryland and Nebraska. Maine would allow the personal exemptions to disappear, but deploy that extra revenue for a “more targeted refundable credit such as an Earned Income Tax Credit or Child Tax Credit that would be even more helpful to lower-income families.”
- Reconsidering the entire state income tax structure, as in Vermont, Minnesota and Utah.

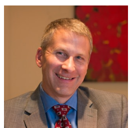
Finally, ITEP addresses certain work-arounds, which we have detailed in the past. These include

New York’s proposal to shift from an income tax to a payroll tax to offset the cap on the deduction for state and local taxes. Likewise, several states, like California, Connecticut, Illinois, Nebraska, New Jersey, New York, Virginia, and Washington, “would convert some or all state or local tax payments into fully-federally-deductible ‘charitable contributions’ by allowing taxpayers to ‘contribute’ to a special fund and then receive a dollar-for-dollar credit, which has no net effect on revenues but circumvents the SALT cap.”

Nexus

Beyond their attention on the Tax Cuts and Jobs Act’s consequences, states are also increasingly focused on laws governing the permissibility of taxing online sales. One of our latest articles addresses the stakes in the case *South Dakota v. Wayfair*, in which the United States Supreme Court heard oral arguments a few weeks ago. Depending on the outcome, expected in June, states stand to gain much more power over capturing the heretofore lost tax revenues from online sales attributed to sellers with no physical presence in the state. The South Dakota law at issue requires online retailers to collect and remit sales taxes if they have gross revenues of at least $100,000 on services or goods shipped into South Dakota, and 200 or more separate transactions that result in the delivery of services or goods into the state.

The Supreme Court set the stage for the *Wayfair* showdown with the 2016 case *Direct Marketing Association v. Brohl*. There, the court left in place Colorado’s law, which requires out-of-state sellers to comply with notice and reporting obligations related to those retailers’ sales to in-state purchasers that are not subject to sales tax collections.



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