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New Federal Tax Law: Individual State Conformity Laws Will Impact State Taxable Income

As a follow up to our recent blog titled <u>New Federal Tax Law: Forecasting State Revenues & Conformity Decisions</u>, NASBO staff reviewed the Congressional scorekeepers' analysis related to federal taxable income changes. Changes to federal tax rates have no bearing on state tax rates, but changes in federal taxable income, adjusted gross income, exemptions and deductions will impact state taxable income – and therefore, state revenues – depending on how a state's tax laws conform to the federal tax code. Over the course of the next several months, each state will make decisions about their existing conformity laws.

Below are characteristics of state conformity laws that will impact state taxable income, which states are affected by each, and the likely impact on state revenues.

1. Six States Tie to Federal Taxable Income

Impact: A rise in state income tax revenues

Nationwide, federal taxable income is expected to rise under the new law. Six states (Colorado, Idaho, Minnesota, North Dakota, Oregon-which uses its own standard deduction and personal exemption, and South Carolina) use federal taxable income as a starting point for their state taxable income calculations, with some state-specific income additions and subtractions. If federal taxable income rises in in these states, state taxable income will rise because the elimination of the personal exemptions and limits on itemized deductions will outweigh the nearly doubled federal standard deduction.

2. 30 States Tie to Federal Adjusted Gross Income

Impact: A modest rise in state income tax revenues

Thirty states use federal adjusted gross income (AGI) or federal gross income as a starting point for their state taxable income calculations, with many state-specific income additions and subtractions. AGI is determined before applying personal exemptions and standard or itemized deductions. The federal tax legislation made few changes to "above-the-line" items that affect federal AGI: alimony paid and received, moving expense deductions, deduction for income attributable to domestic production activities, and bicycle commuting reimbursements. Nationwide, federal AGI is expected to rise under the new law. If that occurs in these states, state taxable income will rise, though by a modest amount.

3. Eight States Use the Federal Personal Exemption

Impact: A rise in state income tax revenues

The new federal tax legislation eliminated the personal exemption (\$4,050 per exemption for the 2016 tax year). Eight states use the federal personal exemption (five of the six states that tie to federal taxable income, mentioned above, plus Maine, New Mexico, and Utah). For these states, state taxable income will rise. From a tax policy perspective, the federal personal exemption was

partly replaced with an increase in the child tax credit. The child tax credit is a reduction to federal taxes owed; it does not affect either federal adjusted gross income or federal taxable income, the two income amounts that 36 states use as their starting point. Other states, including Delaware, Illinois, Indiana, Kansas, Louisiana, Maryland, Michigan, Missouri, Nebraska, New York, Ohio, Oklahoma, Oregon, Rhode Island, West Virginia and Wisconsin, tie the number of personal exemptions to the number of exemptions used in the federal tax return, then apply their own state exemption amount to it. State taxable income will rise in those states unless they elect to modify their state laws to continue having a state personal exemption.

4. Eight States Use the Federal Standard Deduction as their State Standard Deduction Impact: A fall in state income tax revenues

The federal standard deduction nearly doubles with the new federal tax legislation. Eight states use the federal standard deduction as their state standard deduction (Colorado, Idaho, Minnesota, Missouri, New Mexico, North Dakota, South Carolina, and Utah). If more taxpayers use the federal standard deduction instead of itemized deductions as expected, federal taxable income will fall under the new law as a result. If that occurs in these states, state taxable income will fall.

5. Nine States Tie to Federal Standard or Itemized Deduction Usage

Impact: A rise in state income tax revenues

At least nine states mandate that a state tax filer use the same standard or itemized deduction method as they use on their federal return (Georgia, Kansas, Maine, Maryland, New York, North Carolina, Oklahoma, Utah, and Virginia). More taxpayers are expected to use the standard deduction instead of itemized deductions. If that occurs in these states, state taxable income will rise because in all four of these states the state standard deduction amount is lower than the federal standard deduction.

6. Six States Allow Federal Taxes to be Deducted

Impact: A rise in state income tax revenues

Six states allow federal taxes to be deducted from their state taxes (Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon). Three allow full deductibility: Alabama, Iowa and Louisiana. Missouri, Montana and Oregon have dollar limits. In aggregate, federal taxes will fall under the new law. If that occurs in the six states with no dollar limits, state taxable income will rise.

7. States' Relationship to Federal Itemized Deductions

Impact: A rise in state income tax revenues

The most complicated impact on state personal income taxes is the various ways that states use federal itemized deductions in their state tax laws. Over half of the states use federal itemized deductions as a starting point for their state itemized deduction calculations. Most of them exclude state and local taxes paid – the itemized deduction that had the biggest change in the federal tax legislation. The other changes to itemized deductions are:

- limiting the mortgage interest of new loans of more than \$750,000 instead of \$1,000,000,
- eliminating mortgage interest deduction of home equity loans,
- limiting casualty losses to only federally declared disasters,
- the elimination of other miscellaneous deductions subject to the two percent floor,
- increasing the AGI limitations on charitable cash contributions to 60 percent from 50 percent, and
- for tax years 2017 and 2018, lowering the AGI threshold for deducting qualified medical expenses from 10 percent to 7.5 percent.

Fewer taxpayers are expected to itemize deductions or may itemize less, which will cause state taxable income to rise.

8. Seven States Conform to the New Federal Pass-Through Deduction

Impact: A fall in state income tax revenue

The six states that use federal taxable income as their starting point, plus Montana which conforms to that section of the federal tax code, will have a fall in state taxable income because of the new deduction of 20 percent of qualified business income from certain pass-through entities. The deduction may not exceed 50 percent of the pass-throughs' employees' W-2 wages.

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