SALT Alert! 2017-26: State Tax Implications of "The Unified Framework for Fixing Our Broken Tax Code"

First it was the Blueprint, then the infamous one-pager. Most recently, the White House, Republican leaders of the U.S. House and Senate, and the chairs of the House and Senate tax writing committees released a "unified framework" for tax reform. As with the previous tax reform documents, the framework is a very high level document that includes few details on the various proposed changes; instead, it tends to set forth objectives and indicates that the tax writing committees will provide details. The framework is also generally silent on the timing of these proposed changes (with one significant exception). Despite the lack of specifics, as with the other plans, it is possible to generally describe the state and local tax considerations stemming from the proposed federal reform. Below is a high-level summary of the more significant proposed changes that would affect states and/or state business taxpayers.

Proposed Rate Reductions

In addition to individual income tax rate reductions, the framework proposes a 20 percent tax rate for C corporations and a maximum 25 percent rate applied to the "business income of small and family-owned businesses conducted as sole proprietorships, partnerships and S corporations." The framework indicates that the congressional committees will adopt measures to prevent the re-characterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate.

Viewed in isolation, federal corporate and pass-through income tax rate reductions would not directly affect states because state income taxes are not computed as a percentage of federal tax liability. However, should these rate reductions become law, there would be some indirect consequences for the states and state taxpayers. If the federal corporate income tax rate drops to 20 percent, then state corporate income taxes will likely become a much more significant part of a company's overall effective tax rate. This may cause some corporate taxpayers to shift more attention to their now-comparatively-larger state income tax burden. It may well also likely increase attention to the availability of various state-level incentives available for locating economic activity within a particular state.

Proposed Tax Base Changes

As with the Blueprint and most other reform proposals, the framework proposes to offset some of the revenue impact of the rate reductions by repealing various tax preferences and broadening the tax base. This could affect state tax systems. Nearly every state conforms its state corporate and personal income tax in some manner to the corresponding federal tax. In large part, states begin the computation of state taxable income with federal taxable income

and therefore allow, for state tax purposes, many federal deductions. The framework mentions eliminating certain federal deductions for individuals and businesses. If deductions that states conform to were eliminated, the state income tax base would be affected. There are few details on the deductions that would be eliminated, but the framework does specifically state that the Section 199 Domestic Activities Production Deduction would no longer be needed due to the reduced rate structure. Many states currently decouple from the section 199 deduction; those that do not would see their base expand if this deduction were eliminated. On the individual income tax side, the framework envisions keeping the home mortgage interest deduction and the deduction for charitable contributions. While not specifically stated, it appears the deduction for state and local taxes could be eliminated or limited in some manner.

Eliminating the state and local tax deduction could have an indirect effect on the states, particularly high income tax rate states, such as California and New York, where individual taxpayers benefit greatly from the ability to deduct state and local taxes in computing their federal tax liability. Eliminating this deduction, which is characterized by some as a federal subsidy of state and local governments, may potentially put pressure on these states to reduce personal income tax rates.

Immediate Expensing

The framework proposes allowing businesses to expense immediately the cost of new investments in depreciable assets other than structures for at least five years. This rule is proposed to apply to investments made after September 27, 2017 (i.e., the date the framework was released). Given that any new expensing deduction would likely occur in the course of computing federal taxable income, a state's corporate income tax regime would conform to the federal expensing provisions, unless the state chooses to decouple or chooses not to update its conformity date to incorporate the IRC in effect for the period that includes tax reform. In the recent past, states have shown a widespread propensity for not conforming to federal efforts to stimulate investment by accelerating depreciation deductions. Failure to adopt these federal provisions is often because of the negative revenue impact of such measures and state balanced budget requirements. Thus, it is likely that certain states would decouple or not affirmatively adopt these immediate expensing provisions.

Limiting Net Interest Deductions

The framework proposes partially limiting the deduction for net interest expense incurred by C corporations. The framework does not detail how this would be accomplished, but instructs the tax writing committees to address the appropriate treatment of non-corporate interest. States generally conform to IRC section 163, which addresses the deduction for interest expenses. So, to the extent the limitations on the deductibility of interest were incorporated into section 163, they would be adopted by rolling conformity states or states that updated their fixed-date conformity to capture the IRC in effect for the period that includes tax reform (unless such states choose to decouple). What will be more interesting (and potentially complex) is how these federal limits would coexist with limits on the deductibility of interest that are currently applied in a number of states.

Move to a Territorial System and Mandatory Repatriation

The framework proposes to exempt foreign profits repatriated to the United States by replacing the current worldwide system with a 100 percent exemption for dividends from foreign subsidiaries in which the U.S. parent owns at least a 10 percent stake. To transition to the territorial system, the framework proposes treating foreign earnings that have accumulated overseas under the current system as repatriated. The funds deemed to be repatriated would be subject to tax at some unspecified, but presumably reduced, rate. Accumulated foreign earnings held in illiquid assets would be subject to a lower rate than foreign earnings held in cash or cash equivalents. Payment of the tax liability would be spread out over several years.

The impact of these proposals on state business taxes is unclear due to the lack of detail in the framework. Ultimately, the state implications would depend on several factors including, but not

limited to, the manner in which the change would be implemented at the federal level, state conformity to the federal base, current state treatment of income from foreign entities, and other provisions of state law.

Conclusion

The framework continues many of the themes that had been present in the Blueprint and the one-pager – individual and corporate rate reductions, a reduced rate for pass-through business income, base broadening through the repeal of unspecified deductions and credits, enhanced expensing for some assets, reduced tax on repatriated earnings, and moving to a territorial system. While the framework is far from a comprehensive tax bill, it is anticipated to be the starting point for the tax-writing committees as they flesh out the details of tax legislation. As that happens and draft bills become available, there should be greater insight as to how the framework's guidelines would affect state revenues and state taxpayers if federal tax legislation ultimately were enacted. At that point, state taxing authorities may be able to score the state fiscal effect of the proposed federal changes. It is expected that the states' balanced budget requirements will have a bearing on whether federal changes are adopted.

It is also important to consider the overall picture. To the extent that federal tax revenues are reduced as a result of tax reform, there could be changes to the federal budget and reductions in the amount of funds that ultimately flow to the states. The federal government is, after all, the second greatest source of revenue for the states. The President's proposed budget includes reductions to many programs that benefit states. To the extent that states see reduced funding from federal sources, they may have to either discontinue providing certain services and funding some programs or raise the required revenues to replace the federal funds. This would place increased pressure on the states, many of which are already facing budget shortfalls and declining tax revenues.

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