



A Presentation to the House Taxes Committee

on

# **Federal Tax Conformity**

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House Research Department

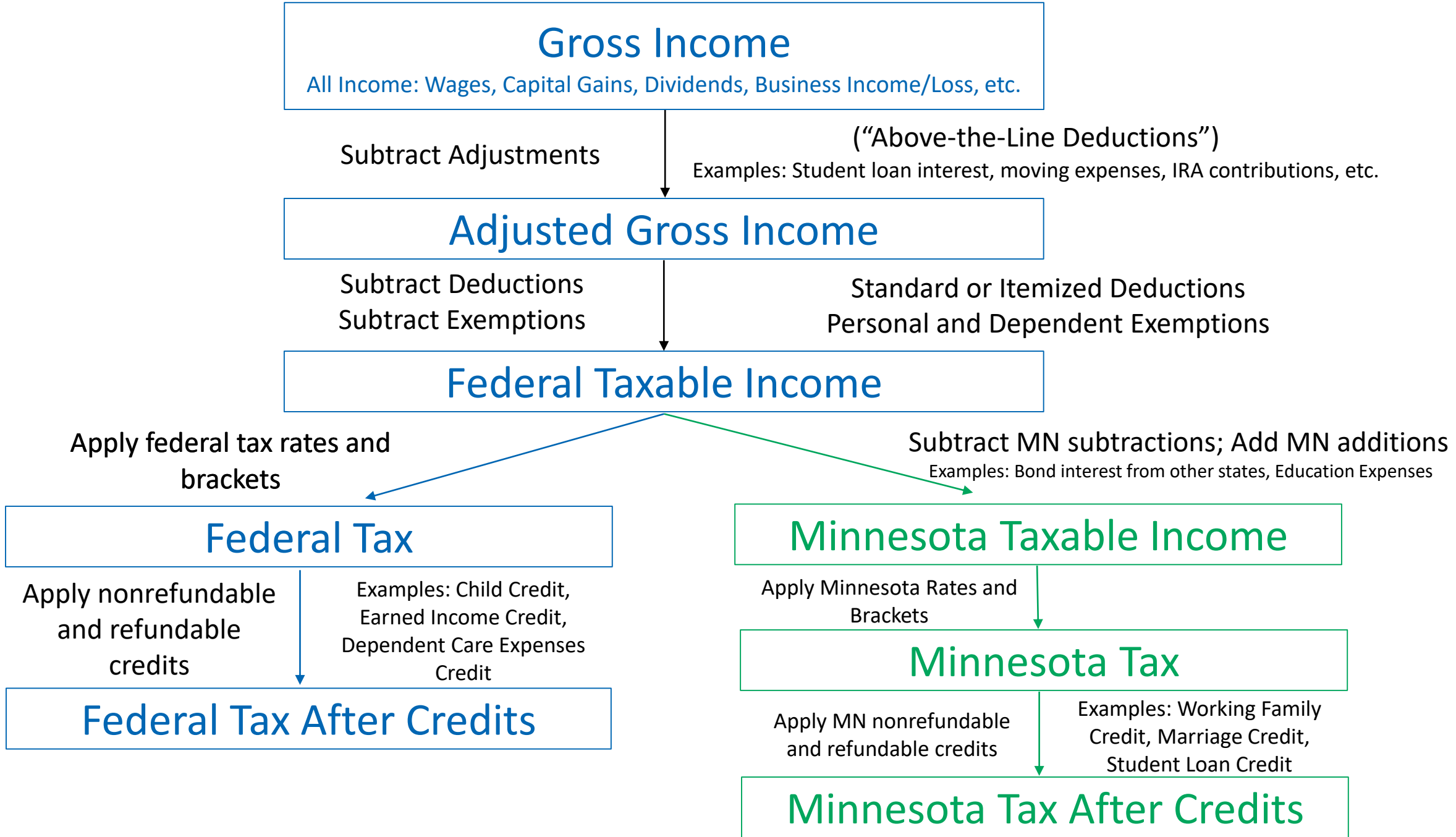
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# What is Tax Conformity?

- Minnesota's income tax uses Federal Taxable Income (FTI), as defined in the federal Internal Revenue Code (IRC), as its starting point. Our tax calculation relies on many federal calculations and definitions.
- Minnesota is a “static date” conformity state. This means that that our tax code is tied to the version of the Internal Revenue Code, as amended through a particular date. Currently we are tied to the IRC, as amended through December 16, 2016.
- Three federal tax laws have been enacted since December 16, 2016:
  - December 2017: Tax act commonly referred to as the Tax Cuts and Jobs Act (TCJA)
  - March 2018: Bipartisan Budget Act
  - September 2017: Disaster Tax Relief and Airport and Airway Extension Act

# Calculating Federal Taxable Income



# States Vary in their Use of Different Tax Bases

- As of 2019, 5 states used Federal Taxable Income (FTI): Minnesota, Colorado, Idaho, North Dakota, & South Carolina.
  - Vermont moved to FAGI as its starting point in 2018 (as part of tax conformity legislation).
- 28 states use Federal Adjusted Gross Income (FAGI).
- 8 states use Gross Income or their own definition of income.
- 9 states have no income tax.

# Among States with an FAGI base, Standard Deductions Vary

- 18 of 27 FAGI states have smaller standard deductions than the federal standard deduction (in tax year 2017).
- 9 of 27 FAGI states have standard deductions equal to or greater than the federal standard deduction (in tax year 2017)—these are shaded in grey.

# Provisions of TCJA that affect Minnesota's Income Tax

# TCJA Provisions are Scheduled to Expire

- Most changes to individual taxes under TCJA expire on December 31, 2025, unless Congress acts to extend or make them permanent.
- If Congress takes no action, the tax system would revert to old law for tax year 2026.
- Provisions that are permanent or expire prior to tax year 2026 are explicitly noted.



# Repeal of the Personal and Dependent Exemptions

- Under old law, taxpayers would have subtracted \$4,250 for each exemption in tax year 2019.
- Personal Exemption:
  - *Old law:* Married joint filers received 2 personal exemptions, other filers received 1 personal exemption.
  - *TCJA:* Repealed; offset for some filers by increase in the standard deduction.
- Dependent Exemption:
  - *Old law:* All filers received 1 exemption per dependent.
  - *TCJA:* Repealed; offset by expanded child credit (for children 16 and younger) and new \$500 credit for other dependents.

# Increase in the Standard Deduction

<b>Filing Status</b>	<b>Old Law, Tax Year 2019 Projected</b>	<b>Amount + personal exemption</b>	<b>TCJA Tax Year 2019</b>
Single	\$6,650	\$10,900	\$12,200
Married Filing Jointly	\$13,300	\$21,800	\$24,450
Married Filing Separately	\$6,650	\$10,900	\$12,225
Head of Household	\$9,750	\$14,000	\$18,350

# TCJA: Changes to Itemized Deductions (1/3)

- Modifications to the Home Mortgage Interest Deduction
  - Repeal of deductibility of interest on home equity loans.
  - Reduces amount acquisition indebtedness eligible for the deduction from \$1 million to \$750,000 (effective for indebtedness incurred after December 15, 2017).
- Repeal of Casualty and Theft Loss Deduction
- Charitable Contributions Deduction
  - Increase in charitable contribution limit from 50% to 60% of AGI.

# Changes to Itemized Deductions (2/3)

- Modifications to the Taxes Paid deduction (State and Local Tax Deduction, or SALT)
  - Businesses retain right to deduct taxes assessed at the entity level.
  - Individuals may deduct up to \$10,000 (\$5,000 married separate) of state and local property, income (or sales), war profits, and excess profits tax. Limitation is not indexed for inflation.
  - Limit on Minnesota liability is blunted somewhat because the state already adds back state income taxes. SALT limitation only affects state liability for filers with more than \$10,000 in property taxes.

# Changes to Itemized Deductions (3/3)

- Medical expense deduction
  - Old law allowed deduction for medical expenses in excess of 10% of AGI. In tax years prior to 2017: AGI floor was 7.5% for filers ages 65 and older.
  - TCJA lowers AGI floor to 7.5% for all filers (effective in tax years 2017 and 2018 only). Returns to 10% for all filers in TY 2019.
- TCJA repeals all “Miscellaneous itemized deductions” subject to the 2% AGI floor.
  - Tax preparation expenses
  - Unreimbursed employee expenses
  - Expenses for the production or collection of income

# More Taxpayers will Claim the Standard Deduction

- Under old law, House Research modeling estimates:
  - 64% of returns (about 1.83 million) would have claimed the standard deduction in TY 2018
  - 36% of returns (about 1.02 million) would have itemized
- Under the TCJA, we estimate:
  - 88% of returns (about 2.50 million) will claim the standard deduction in TY 2018
  - 12% of returns (about 350,000) will itemize
- Amount subtracted through the nonitemizer charitable contribution subtraction forecast to increase 361%

# Change to Inflation Indexing

- Federal tax system moves from the Consumer Price Index for All Urban Consumers (CPI-U) to the Chained Consumer Price Index for All Urban Consumers (C-CPI-U).
- Chained CPI accounts for ability of consumers to change their consumption habits when prices increase by substituting for other goods. It also uses different “weights” for the basket of consumer goods used to estimate inflation that are more current.
- Chained CPI tends to increase more slowly than CPI-U. This means that provisions that are indexed for inflation will grow more slowly than they did under old law.
- This change is permanent.

# Other Changes

- Student loans discharged due to death/disability no longer counted as income.
- Section 529 College Savings Plans: \$10,000 per taxable year in distributions may be used to pay for elementary and secondary school tuition.
- Opportunity Zones: established by TCJA; investments in these zones get preferential capital gains treatment (step up in basis, potentially up to 100% of market value).



# Individual Income Tax Policy Choices Facing the Committee

- Should the state retain federal taxable income (FTI) as its starting point and thereby adopt TCJA's itemized and standard deduction changes? Or shift to FAGI and set its own itemized deduction and standard deduction rules?
- Under either approach the state will need to adopt a family size adjustment because TCJA suspends the federal dependent exemption
- Conform to Chained CPI as inflation measure?
- How to balance simplification with reducing winners and losers.

# Retaining FTI as the State's Starting Point

<b>Reasons to Retain FTI</b>	<b>Reason to Switch to FAGI</b>
Simplification: no need to define Minnesota itemized and standard deductions.	FTI no longer includes family size adjustment; state must set its own.
Eliminates Minnesota-only filing requirement (if state standard deduction is less than federal standard deduction).	Retaining FTI creates winners (those who benefit from the standard deduction) and losers (itemizers who lose personal exemptions).
A large standard deduction is also a simplifying measure—eliminates need for taxpayers to keep records of itemized deductions for Minnesota purposes only.	Gives Minnesota policymakers more control over tax policy levers—legislature can adopt higher standard deduction if it considers that the best policy choice.
Reinforces incentive effects under federal tax (e.g., in itemized deductions).	Legislature disagrees with Congress's policy choices on deductions and exemptions.

# Adopting TCJA's Changes to Itemized Deductions

<b>Reasons to Conform</b>	<b>Reasons not to Conform</b>
Simplification	Creates winners and losers.
You may believe the deductions were inefficient or ineffective at achieving their policy goals.	You may believe that the deductions were effective and efficient mechanisms for achieving their policy goals.
Raises revenue that could be used on tax policy that benefits a broader group of taxpayers (e.g. rate reductions, increases in the standard deduction).	May create significant tax increases among individuals claiming the deduction.

# Family Size Adjustment

- Establish Minnesota Dependent Exemption that broadly replicates the dependent exemption under old law.
  - Doesn't create winners and losers.
  - Exemption is more valuable to taxpayers with higher marginal tax rates. Mitigated somewhat because exemptions begin to phase out at ~\$292,000 for married couples filing joint returns.
- Establish a state child tax credit.
  - More progressive—provides an equal benefit to taxpayers regardless of marginal rate.
  - If revenue neutral, creates winners (those with lower marginal rates) and losers (those with higher marginal rates).

# Individual Income Policy Tradeoffs in a Conformity Bill

- Any conformity bill will produce both winners and losers. Income tax modeling can only capture the distributional effects of certain provisions.
- Any conformity bill is likely to reduce the simplicity of the state's tax code (because FTI no longer includes a family size adjustment).
- Policy question facing the committee is how to balance competing tax policy priorities—simplicity, equity, ease of administration, transparency, economic efficiency, revenue adequacy. Most conformity choices involve tradeoffs between these priorities.

# Business Provisions of TCJA

Conformity items with revenue effect > +/- \$10 million/year in FY2019

# Qualified Business Income (QBI) Deduction

- This is an entirely new provision—no analogue in prior law.
- Allows sole proprietors, partners, and S corporation shareholders to deduct 20% of their income, subject to a complex web of limitations based on combinations of amount of income, type of business, amount of wages paid and/or qualified property.
- QBI deduction is a hybrid: it is computed after calculating AGI (i.e., it is not an above-the-line deduction). But it is also not an itemized deduction. It WILL affect FTI, if Minnesota continues to use FTI.

# Section 179

- Section 179 allows businesses making qualifying capital expenditures to “expense” them (i.e., to deduct the full amount in the year made), rather than requiring multi-year recovery deductions.
- Prior law limit was \$500,000, phased out for amounts over \$2 million.
- TCJA expands this to \$1 million with \$2.5 million phase-out.
- More types of real property qualify under TCJA.
- Minnesota has not conformed—requires add-back of 80% and deduction of add-back over next 5 tax years.



# Bonus Depreciation

- Bonus depreciation allows accelerated allowance of the deduction for capital expenditures on depreciable property—50% of the basis of qualified property can be deducted in the year placed in service under pre-TCJA law.
- TCJA significantly expands the bonus depreciation rules:
  - Increases to 100% (rather than 50%)
  - Allows more property to qualify – e.g., used property
- Minnesota has not conformed—requires add-back of 80% and deduction of add-back over next 5 tax years.
- This is a temporary provision and will phase out beginning in 2023.

# Loss Limitation Rule

- Prior law limits the ability of investors to reduce other income by passive losses. Active participants, however, are allowed to use business losses (even if the business is per se passive, like real estate) to reduce their other income.
- TCJA limits the deductibility of excess business losses (more than \$500,000 for married joint or \$250,000 for others) to reduce other income. The disallowed amount becomes an NOL but only can be carried forward.

# Small Business Accounting Reform

- Prior federal law allowed a limited set of businesses (e.g., farmers, sole proprietors, personal service corps, those with limited gross receipts, etc.) to use cash basis accounting, a simpler and administratively easier method than the accrual.
- TCJA expands the businesses that can use cash basis accounting—more farm businesses will qualify; gross receipts test changed and raised to \$25 million (from \$5 million), inventory rules loosened, etc.
- DOR determined that existing statute allows any taxpayers to use cash accounting where they are federally permitted—effectively conforming to this provision.

# Interest Deduction Limitation

- Under prior law, business interest is generally deductible.
- TCJA imposes limits on business interest deductions. This is considered to be a feature of allowing expanded expensing of capital expenditures; allowing both the expenditure and the interest to carry could be considered to allow deducting those costs twice.
- Generally deduction cannot exceed 30% of adjusted taxable income; disallowed amounts carried forward.
- Car dealers allowed continued deductibility of all floor plan interest. Small businesses (avg. annual gross receipts < \$25 m in prior 3 years) also exempt.

# Net Operating Losses (NOLs)

- Federal and Minnesota law allows individuals with business losses a 2-year carryback (i.e., they can file amended returns and reduce their prior year's income and tax using the loss or NOL) and a 20-year carryforward. This applies to the full amount of the losses.
- TCJA limits NOLs to 80% of taxable income and repeals the 2-year carryback (except for farmers).
- Minnesota's corporate NOLs are calculated under a Minnesota-specific statute that does not follow all of the federal rules.

# Limit Employer Deductions

- Under prior law, employers are allowed to deduct (as a business expense) 50% of the cost of paying for certain meals and entertainment expenses and the full cost of qualified transportation fringe benefits for their employees.
- TCJA eliminates the deduction for entertainment and meals (subject to certain exceptions) and for qualified fringe benefits. (This does not make the benefits taxable to the employees, however, if they were not under prior law.)

# Repatriation Tax

- TCJA imposes a low-rate federal tax on deferred foreign earnings of controlled foreign corporations and certain other foreign corporations owned by domestic corporations. This tax deems these deferred foreign earnings to be subpart F income for tax year 2017. TCJA allows this tax to be paid over 8 years.
- Conforming to the TCJA (i.e., by updating the IRC reference) would subject this income to Minnesota tax. MN law treats subpart F income as a dividend that qualifies for the 80% dividend received deduction. The tax on this income would be further reduced by the recipient's Minnesota apportionment percentage.
- Preliminary DOR estimates indicate conformity would raise revenues for FY 2019 by \$162 million. **This revenue (likely collected over 8 years) is one-time.**
- Economists expect that TCJA will cause some corporations to voluntarily repatriate this income by paying dividends. This effect is providing increased state revenue **without** passing a conformity bill. This revenue will be reflected in the MMB's forecasts.

# Global Intangible Low-taxed Income (GILTI)

- TCJA moves the federal tax from a worldwide tax with deferral of foreign operating income until repatriated (with a foreign tax credit) toward (but not all the way to) a “territorial” tax that exempts foreign income.
- To minimize the incentive that a territorial tax has to relocate income from intangibles to low-tax foreign jurisdictions, TCJA requires GILTI to be included in FTI—effectively like subpart F income. Computation of GILTI is done under a complicated formula that tries to tax income earned by controlled foreign corporations and certain other foreign corporations above an assumed return of 10%.
- Because GILTI is added to FTI, updating the IRC references (w/ other changes) would subject this income to Minnesota tax as a dividend (80% deduction applies).



# Foreign-derived Intangible Income (FDII) Deduction

- In addition to the GILTI (an anti-abuse provision), TCJA provides a carrot or incentive for domestic corporations to export their goods and services (rather than using or producing them through foreign corporations).
- FDII uses complicated calculations to determine a deduction for domestic corporations with intangible income derived from foreign operations. The rates and terms used to compute the deduction vary over time. Conforming will allow this deduction for Minnesota purposes, since it reduces FTI.

# Retroactivity

- Significant complexity due to the state's use of the old IRC for tax year 2018.
  - Different qualifying property for expensing purposes.
  - NOL carrybacks and carryforwards.
- Retroactivity may mitigate complexity.
  - Voluntary and mandatory amended returns.
  - Catch-up additions or subtractions.
- Repatriation money is returned for tax year 2017 and reported in that year.

# Policy Considerations

- How to spend base broadeners (international provisions, limits on NOLs, EBLs, and the interest deduction and repeal of employer deduction)?
  - Increase standard deduction.
  - Full or partial conformity on section 179/bonus.
  - Corporate rate reduction.
- How to spend one-time money? Possible budget risk if permanent expenditures are not matched to permanent revenue sources.