TAX POLICY CENTER
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Conformity, COVID-19, and State Budgets

Presentation for the Governor's Council on Tax Reform

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Overview

- Primer on federal-state tax conformity
- Analysis of SB 22
- State fiscal trends during the pandemic and how Kansas compares

What is “conformity”?

What is federal-state tax conformity?

- When a state uses federal rules in its own tax code it is "conforming"
  - Imagine the state literally copy/pasting the federal law into its code
  - "Rolling" conformity (Kansas) means any federal change is automatically copy/pasted in; "static" conformity means the state must approve the copy/paste
- States most often conform with definitions of income
  - This could be something relatively simple, like whether Social Security income is taxable income
  - This could be something incredibly complex, like establishing taxable income for a multi-national corporation
- The most important thing to keep is mind is conformity is <u>always a choice</u>

Why do states conform? Why do they decouple?

- States conform because doing so makes taxes simpler
  - Simpler for the filer: fewer documents, fewer calculations
  - Simpler for the government: the state tax administrators can rely on the IRS, US Treasury, and federal courts for regulation, guidance, and compliance
- States "decouple" (i.e., do not conform) when the federal law is not a good fit for the state—when something is more important than simplicity
  - There is <u>no rule</u> saying states must conform. In fact, states are under no obligation to use one word of the federal law in their tax code
  - If a federal rule <u>does not fit a state's values or budget,</u> then the state should decouple from the rule

Common and important examples of decoupling

- The federal government taxes a portion of Social Security income, but some states decouple and fully exempt Social Security income
  - States that decouple from the federal rule give an additional benefit to Social Security recipients (same is true when states decouple on some forms of pension income)
- In 2002, Congress passed “bonus depreciation,” which allowed taxpayers to immediately deduct 30% (later 50%) of the cost of new investment in machinery and equipment
  - Congress (which does not have to balance the federal budget) decided this was a good way to boost economic growth
  - However, more than half of the states decoupled and did not allow the deduction. These states decided bonus depreciation (even if well-intentioned) was a bad fit for their budgets
- The questions surrounding conformity may feel new, but conformity is a constant issue. The TCJA and CARES Act are just the most recent examples of federal changes prompting state consideration

Takeaways

- There is always some benefit to conforming—it makes the state tax code simpler
- But simplicity is not the only goal of tax policy
- We also want tax policy to be efficient, equitable, and raise sufficient funds in a way that minimally distorts economic activity
- Thus, it’s up to state policymakers to figure out if conforming with federal rules has any negative consequences. If so, policymakers must decide if they want to follow
- Question: Does conforming with the federal law fit the state’s values and budget?
- Remember: <u>Conformity is always a choice</u>

SB 22

Two major conformity issues in SB 22

1. The tax treatment of three types of business income: PPP loans, business loss carrybacks, and global intangible low-tax income (GILTI)
2. Kansas’s rule that filers must take the standard deduction on their state return if they take the standard deduction on their federal return

Specific business conformity proposals in SB 22

- Kansas law should <u>conform</u> with federal tax rules on PPP loans
  - That is, expenses paid with PPP loans are tax deductible
- Kansas law should <u>conform</u> with CARES Act rules on loss carrybacks
  - That is, businesses can reduce taxable income on their state form just as they have on their federal form
- Kansas law should <u>decouple</u> from federal rules on GILTI
  - That is, corporations should have a different taxable income calculation on Kansas forms and federal forms

The tax treatment of business income is …

- … *extremely* complicated
  - If you have questions on the specifics of any of these policies, please ask. We're more than happy to share what we know
  - However, for your time and my sanity, I will not otherwise dive deep into the tax policy weeds
- Note: All three changes are business tax cuts; but two would conform and one would decouple (the major issue is not "conformity")
- The choice here is rather simple: <u>Do these changes fit Kansas's budget and values?</u>
  - Changes would cost tens of million of dollars. Can the state afford this?
  - Changes would mostly benefit large, multi-state (and multi-national) corporations. Is this how Kansas wants to spend its limited resources?
- If yes, pass the bill. If no, don't.

Understanding the issues surrounding conformity

- **Conforming with federal rules makes Kansas's taxes simpler**
  - True. However, decoupling does not necessarily make the code complex. All three of these policies (PPP loans, loss carrybacks, and GILTI) are calculated and reported on the federal form. Either the amount is included on the Kansas form (conforming) or it is not (decoupling)
  - While simplicity is good, it is not a major issue in these cases. Different states take different approaches to all three policies—both conforming and decoupling is normal
- **Conforming with PPP and loss carrybacks and decoupling from GILTI would lower business taxes**
  - Absolutely. But so would lots of other tax changes.
  - The important questions are: What type of businesses are these tax changes helping? Can Kansas afford these changes? Do these changes primarily impact the Kansas economy? What do Kansas businesses need to succeed (it's not just tax cuts)?

Different states have different approaches on all three business tax issues

- Maine, Virginia, and other states are debating decoupling from the federal tax treatment of PPP loans—because this is a budget issue
- Colorado, Georgia, Hawaii, New York, and North Carolina have already decoupled from provisions in the CARES Act—because this is a budget issue
- Roughly half the states conform and tax GILTI—because this is a budget issue

What are we actually debating?

- The policy details about business taxes and conformity can be very confusing
- But the debate is simple: Given budget constraints, is that the best use of state funds?
  - Tax cuts can help businesses that are struggling during the pandemic and stimulate the economy. Do these specific tax changes help the businesses you want to help?
  - Residents might also need tax relief. Can you assist these businesses and residents?
  - Businesses and residents rely on education, workforce development, infrastructure, and other critical drivers of economic development. Can you deliver on these other obligations and pass these tax changes?

The standard deduction rule

- Kansas, like some other states, requires a filer to take the state's standard deduction if she takes the federal standard deduction
  - This rule's biggest benefactor is the state's tax administrators because it means they can rely on the federal form and IRS for tabulating a filer's itemized deductions and ensure deductions match activity
- Kansas's standard deduction is $3,000 for single filers and $7,500 for married filers
- Issue: 2017's Tax Cuts and Jobs Act (TCJA) increased the federal standard deductions
  - Single: $6,500 to $12,000 (increases with inflation; TY 2020 = $12,400)
  - Married: $13,000 to $24,000 (increases with inflation: TY 2020 = $24,800)
- Result: More Kansans now take the federal standard deduction and thus are getting a lower state standard deduction than their previous itemized deduction amount (thus pay more state tax)
- SB 22 would let filers itemize on their state return even if they take the federal standard deduction

Tax administration problem

- Regardless of the winners and losers and revenue consequences, this change would create a large new responsibility for the state’s tax administration
- Unlike the business tax changes, where the federal government is doing all the work and the state is just taking (or not) a simple number, this change would require Kansas to do the work
- If the state wants to allow filers to create state-based itemized deductions, then the state needs to establish and administrate (and enforce) those rules
- It is possible: 15 states allow filers to itemize even if they took the federal standard deduction
- But no state has changed this rule since the TCJA passed

Winners and losers (or winners and winners?)

- This issue affects a Kansan who pre-TCJA itemized their deductions (e.g., $10,000) and now post-TCJA takes the Kansas standard deduction ($3,000 and $7,500)
- These Kansans now pay more in state income tax because of the change
  - Lower deduction = more taxable income = higher tax liability
- But these Kansans also received significant federal tax cuts
  - Higher deduction = lower taxable income = lower tax liability (plus lower rates and other cuts)
- Who are these Kansans?
  - It would be wrong to describe these filers simply as "wealthy," but they are not lower income. Filers who itemized pre-TCJA typically earn *relatively* high income and own their home.
  - Those that would benefit are Kansans that had been itemizing but now choose not to <u>because they are better off</u> taking standard federal deduction

Example of a “losing” Kansas taxpayer

	Current Law	Pre-TCJA	Change
Federal tax calculation			
Income	75,000	75,000	
- Standard deduction	12,200	--	
- Itemized deductions for state income taxes	--	3,461	
- Other itemized deductions	--	5,000	
= Taxable income	62,800	66,539	
Federal income tax liability	**9,675**	**11,120**	**-1,445**
State tax calculation			
Income	75,000	75,000	
- Standard deduction	3,000	--	
- Other itemized deductions (after 75% adjustment)	--	4,000	
- Personal exemption	2,250	2,250	
= Taxable income	69,750	68,750	
Kansas income tax liability	**3,518**	**3,461**	**57**
Combined federal and state tax liability	**13,193**	**14,581**	**-1,388**

What are we actually debating?

- Changing the standard deduction rule would make the state's tax system more difficult to administer
- In exchange, the state would provide a benefit to some taxpayers
  - These filers pay higher state tax because of TCJA. But they do so because they benefited from the TCJA and now pay less in net state + federal tax
- As with the business tax changes, the question is: Is this the best way to spend Kansas's limited resources as it tries to manage the pandemic and grow its economy?
  - Given budget constraints, is this how Kansas wants to use its limited resources?
  - Given the K-shaped impacts of the COVID-19 pandemic, those who would benefit are not those most hurt by the economic downturn

State budgets and COVID-19

The pandemic: relatively speaking

- There are a lot of media stories about "improving" or "better than expected" state revenues and finances.
- Critical question: Compared to what? Or, compared to when?
- In general, the situation is better than the most pessimistic predictions from the start of the pandemic (when we had no information!) but worse than what was anticipated and hoped for at the start of 2020
- For example, many new executive budgets propose spending more in FY 2022 than actual spending in FY 2021 … but the <u>proposed spending is lower</u> than what the governor originally asked for at the outset of FY 2021

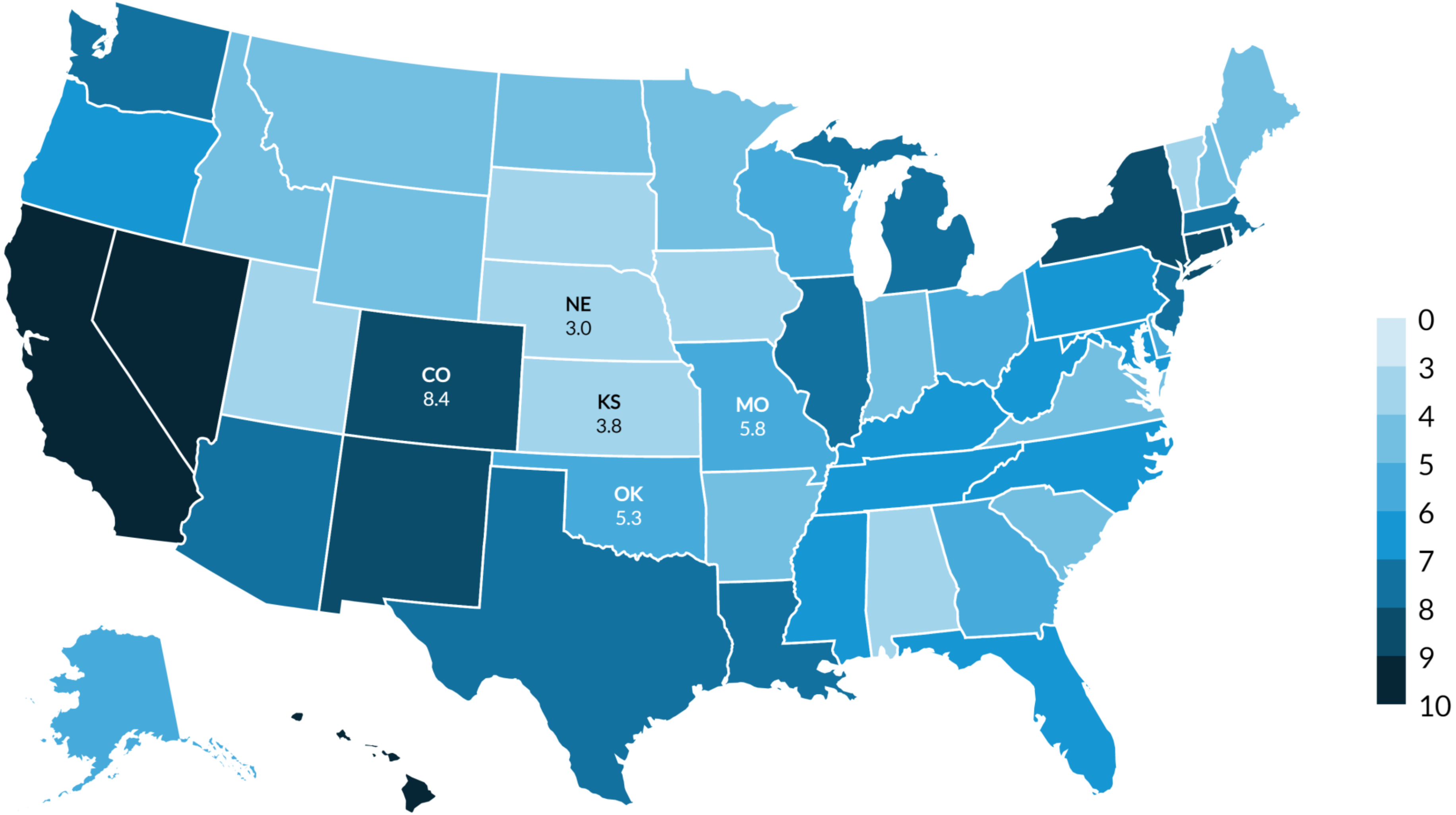
What we know …

- If your state is dependent on accommodation/leisure/tourism … that's bad
- If your state is dependent on sales taxes … that's bad
  - But if your state taxes grocery food … that helps
- If your state is dependent on the oil industry … that's bad
- If your state has a progressive income tax … that's good
  - This is because the economic pain of the pandemic is falling so squarely on lower-income workers who often work in accommodation/leisure/tourism—and who do not often owe income tax (don't earn enough)
  - Higher income workers largely kept their jobs and paychecks (and withholding)
  - The stock market is booming

Actual state tax revenue collections are still down

- Preliminary estimates of collections for April to December (2020 vs. 2019)
  - All states: -1.5%
  - Median state: -2.0%
  - **Kansas: -2.7%**
  - Plain states: -2.4%
- *Based on data from 39 states; includes all Plains states*

Unemployment rate, December 2020 *(percent, seasonally adjusted)*



Source: Bureau of Labor Statistics via the State Economic Monitor

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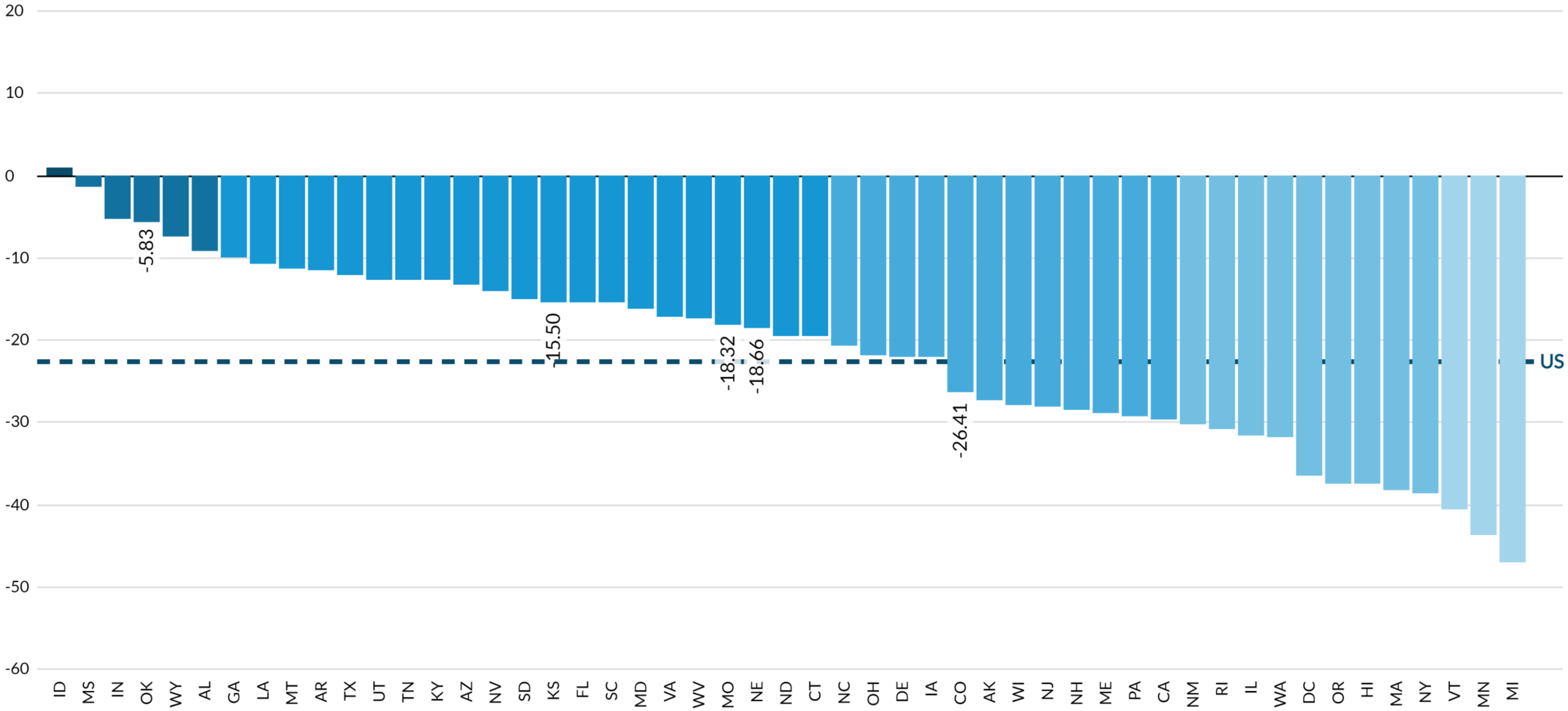
Leisure and hospitality employment, December 2020 *(percent change year over year, seasonally adjusted)*



Source: Bureau of Labor Statistics via the State Economic Monitor

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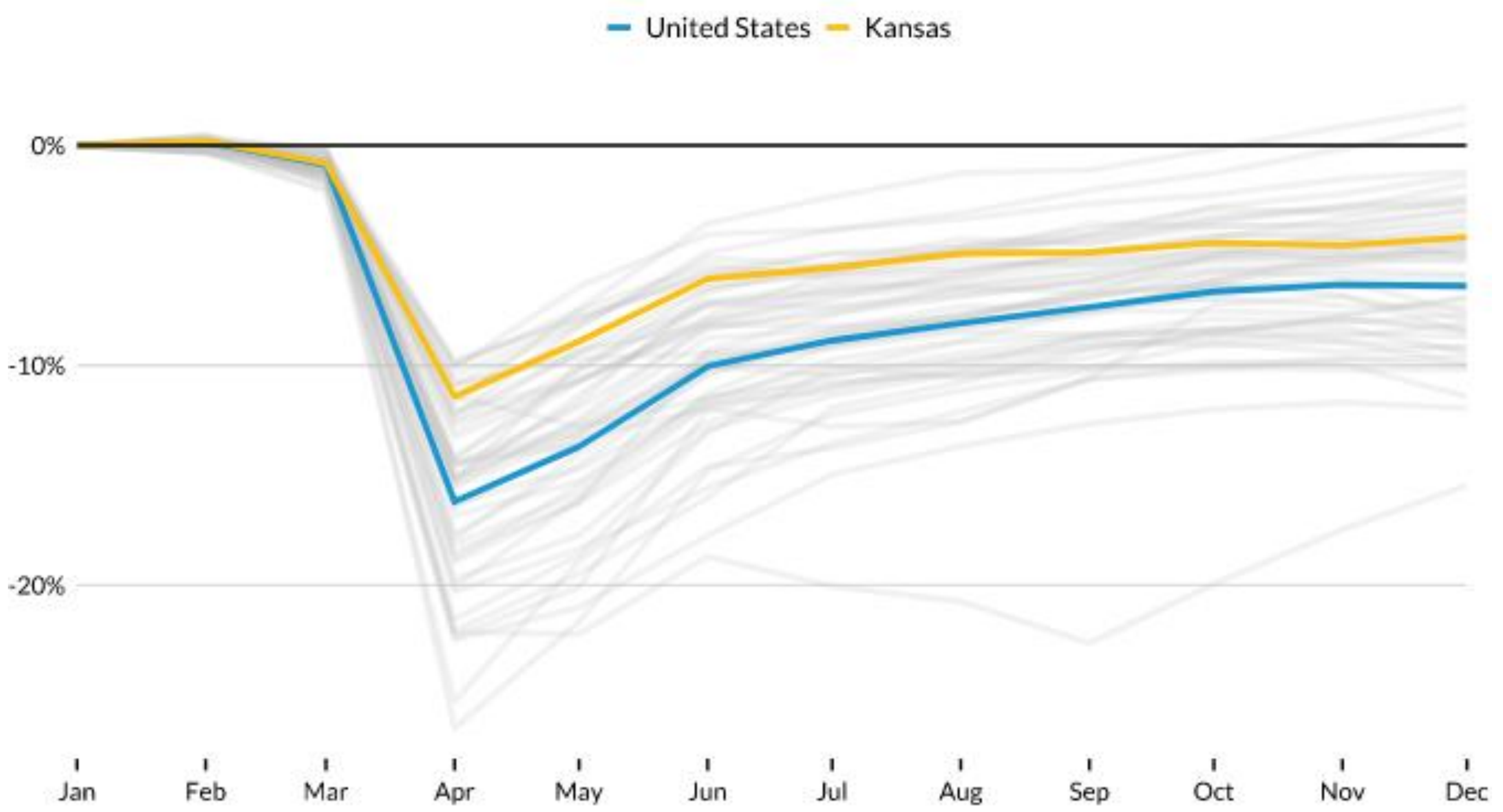
Kansas's Percentage Change in Private Employment

2020



Source: Bureau of Labor Statistics.

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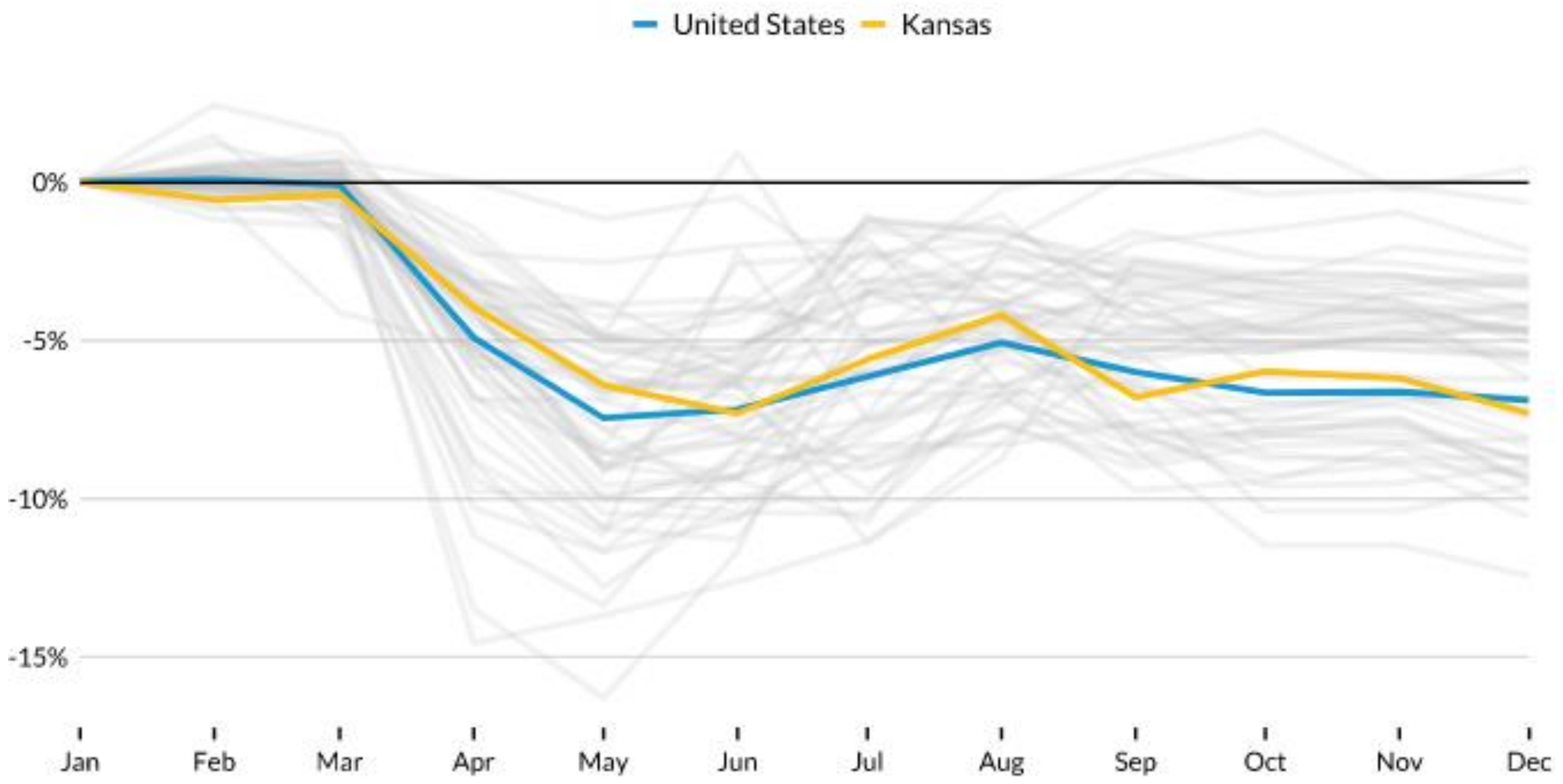
What does this mean for state budgets?

- It’s tough to form a national narrative because different states are taking different approaches to balance their budgets …
- Some relied heavily on federal dollars in the CARES Act (Michigan, Louisiana); others used federal funds for other types of direct relief (North Carolina, Iowa)
- Some are drawing down heavily from reserves (Illinois, Nevada); others are saving them for a prolonged downturn (Ohio)
- Some are proposing income tax increases (New York, Minnesota); others are proposing income tax cuts (Mississippi, South Carolina)

- What we know: We’ve lost 1.4 million state and local government jobs (6.9%)

Kansas's Percentage Change in State and Local Public Employment

2020



Source: Bureau of Labor Statistics.

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Not all bad news: States providing direct pandemic relief

- Colorado, New Mexico, and the District of Columbia provided larger unemployment benefits to residents in 2020
- North Carolina sent direct payments to residents with children (tied to state's child tax credit)
- Governors in California and Maryland are proposing sending checks to residents who qualify for their state's earned income tax credits

What we don't know

- If and when there will be more direct federal aid for state and local governments or, if there is assistance, what it might look like
- How long the pandemic and economic downturn will affect state budgets
  - Even optimistic forecasts are pessimistic about FY 2023 and beyond
- How federal tax changes might affect state budgets
  - Like the TCJA and CARES Act, any new legislation could increase or decrease state tax revenue because of conformity
  - Also, reminder: All the individual income tax provisions in the TCJA expire at the end of 2025

Conclusions

- We know a lot more about the pandemic and economy now than in the spring
  - We know the sectors and workers hit hard by the pandemic, and we know how that is interacting with state (and local) revenue systems
- We still don't know when any of this will return to "normal"
  - Impossible to predict very far into the fiscal future
- We know there likely will be a lot of new federal legislation
  - We have no idea what it will look like and how it might affect state finances
- Kansas should consider what it knows (who the pandemic is hurting) and what it doesn't (fiscal uncertainty) when making any tax or spending decisions

Thank you (and resources)

- How the COVID-19 Pandemic is Transforming State Budgets
  - https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-fiscal-pages-covid-edition
- State Fiscal Briefs
  - https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-fiscal-briefs
- State Tax and Economic Review
  - https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-tax-and-economic-review
- State Economic Monitor
  - https://apps.urban.org/features/state-economic-monitor/