A Complex Form of Three-Dimensional Chess

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Speculation abounds on major federal tax reform in Washington, with proposals ranging from international (lower corporate rates, a territorial system, repatriation incentives, "border adjustability," etc.) to domestic (simplification, lower rates, expensing of capital investments in lieu of interest deductions, etc.). What could these potential changes mean at the state level?

States set budgets (at least in most cases) taking into account expected revenue and expenses. They have to make tough choices on tax policy and spending priorities. The recent trend of state tax revenue falling short of budgeted expectations has exacerbated the problem of state budget deficits. Federal reforms could put further strain on state tax policy decision-making.

Many states have state income taxes that start with adjusted gross income or taxable income as determined under the Internal Revenue Code. Any federal reform that reduces that income (such as with new or expanded deductions) will present a choice between (a) retaining consistency with federal law and the resulting reduced state revenue (applying a static analysis) or (b) decoupling with federal law to avoid the revenue loss, but thereby creating greater complexity for taxpayers and reduced attractiveness of that state's tax climate. However, a reduction in federal or reduced tax rates on repatriated earnings might generate more taxable income, particularly if funded in part through the elimination or reduction in current deductions, and the flow-through might help state revenue. In that case, the analysis of whether to decouple could be much different. Each and every federal change could have a positive, negative, or no discernable impact on states. The magnitude of those impacts will vary with each change and the impact may vary from state to state.

The international proposals present some of the same policy issues, as well as other issues depending on what may be passed. A border adjustment incentive for exports could take the form of a deduction, which may pass through to the states and reduce income absent decoupling, or it could take the form of a credit, which may not pass through to the states. States might also need to revisit how they tax foreign operations and dividends, and adjust to federal law changes.

There are other proposals in Washington that are not labeled as federal tax reform but may affect state tax policy indirectly. Changes to the Affordable Care Act might shift some costs from the federal government to the states, adding further strain on state budgets and affect state tax policy decisions. That shifting of costs could be true in other areas of the federal government as well given the focus on deregulation, such as with environmental policies. Of course, if deregulation leads to increased profitability (such as for financial institutions), that may in turn increase state tax revenue. However, the freeze on regulations in some cases, such as with the new federal partnership audit regulations, creates uncertainty for the states and for taxpayers.

Aside from major federal income tax reform, efforts are still being made to encourage Congress to act on the remote seller sales tax nexus issues (Main Street Fairness-type initiatives), as well as to consider safe harbors for state income tax and withholding tax nexus (BATSA-type initiatives). There is much speculation as to the likelihood of any action on these types of proposals, and it is probably fair to say that these concerns do not appear to be a current priority in Washington. However, that could change and the passage of any of these proposals could greatly affect the states.

One final note that appears outside the current playbook is that from time to time there is talk of replacing our federal income tax with a form of a consumption tax, possibly like the value added tax. It remains to be seen if that concept will be introduced in this process, as predictability does not appear to be the hallmark of today's political environment. A change of that nature could have tremendous state tax implications.

The proverbial devil will be in the details of any tax reform, and those details are not yet known. Nevertheless, it is critically important for businesses and states alike to prepare to react to these changes notwithstanding the multiple possibilities, uncertainty, and lack of detail. Any changes need to be considered at the state level both individually and collectively. This will be a complex form of three dimensional chess.

One outcome of major federal reform seems certain. States will need to react and they will react differently, and those divergent reactions will result in a multitude of disputes with taxpayers.