Strategic Nonconformity to the TCJA, Part I: Personal Income Taxes

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Strategic Nonconformity to the TCJA, Part I: Personal Income Taxes

by Adam Thimmesch, Darien Shanske, and David Gamage

The dire revenue situation that COVID-19 has created for state and local governments is a well-documented and looming reality for state legislatures. We and others have explored a variety of ways that states should respond to this crisis in prior articles as a part of Project SAFE (State Action in Fiscal Emergencies), an academic effort to help states weather the fiscal crisis by providing policy recommendations backed by research. We think, as do many others, that in the absence of sufficient federal action, the states should prioritize raising revenue through targeted taxes on economic actors that are best enduring the crisis, rather than cutting services needed to protect state economies or state residents suffering more from the crisis.

With those background goals, this article focuses on the ways that states could raise revenue by rethinking whether and how they conform to the Tax Cuts and Jobs Act. This article is the first in a planned two-part series, with this article focusing on strategic nonconformity with the TCJA for state-level personal income taxes, and with the planned second article in the series to then focus on strategic nonconformity with the TCJA for state-level corporate income taxes.

The TCJA was signed into law December 22, 2017, and went into effect January 1, 2018. That timing, along with the rushed manner in which the bill was introduced and debated in Congress, meant that states had little time to respond. States that conformed to the tax code on a rolling basis had to affirmatively act if they wanted to decouple from those changes, which obviously put them in a difficult position. Fixed conformity states faced...
similar issues. They had to update their conformity dates if they wanted to adopt the changes in the TCJA and had to affirmatively carve out any modifications that they did not wish to adopt. Most states tended to follow their default positions of conformity and adopted the majority of the TCJA’s changes, with the most notable exception being the treatment of the revenue-raising provisions aimed at U.S. multinationals.

In the flurry of activity surrounding the TCJA, most state legislatures did not think deeply about how their tax bases should relate to the federal base. That response was understandable given that legislatures are busy and that the country was in the midst of an economic expansion. But the time has come for states to take a more careful look at TCJA conformity.

Why States Should Respond Strategically

States have not generally responded strategically to federal tax law, much less to the TCJA. The revenue hole that states now find themselves in should be enough reason for them to change course. But there are several other reasons as well. First, this pandemic has presented states with challenges they could not have anticipated, and recovery will take sacrifice by many for the long-term benefit of the whole community. It might sound hokey to some, but joint sacrifice is important nonetheless. To the extent that some taxpayers are receiving tax benefits at the federal level, asking them to pay more at the state level is, all else equal, a reasonable request.

Second, the scale of the emergency requires a massive federal response, but such a response has not been forthcoming. Clawing back windfalls doled out by the TCJA would be an exercise in self-help akin to how states have had to scramble to get protective equipment for their first responders. If the federal government will not do its job and provide states with the support they need, the states must secure revenue for themselves.

State action as self-help is all the more compelling if the federal government is not doing its job based on a belief that it cannot afford to. We think that belief is false, but even if it were true, the unavailability of funds would be in part a result of Congress giving huge tax breaks during an economic expansion. If the federal government will not claw back that money now that it is desperately needed, the states should do it themselves.

Third, our proposals all represent good tax policy on their own; we are not proposing that states conform strategically for no other reason than that they can. Take our proposal to impose a surcharge on qualified business income (QBI), for instance. If taxpayers responded to our proposed state surcharges on QBI by not distorting their businesses to generate QBI, then our proposal would increase the efficiency of the tax system, including at the federal level.

There is another efficiency benefit to our proposals. Take depreciation. Given the size of the federal tax burden relative to that of any state tax burden, or even many states’ tax burdens, the state-level tax associated with strategic nonconformity will be small. Therefore, firms are likely to respond to the federal incentive and not change their behavior (much) because of the state-level change.

Fourth, as for states with politicians trying to avoid framing their decision against the backdrop of federal failure, there is a parallel argument. If the federal government is correct to be stepping back, then the states have to step up — at least to an extent. In this way, state (and local) governments need to grow in order for the federal government to (safely) recede and for the size of government to shrink overall.

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5 California, a static conformity state, took an intermediate approach. It did not update its conformity date but selected specific provisions in the TCJA that it would conform with. See Kathleen K. Wright, “California Conformity to TCJA (The ‘Light’ Version of Conformity),” Tax Notes State, July 29, 2019, p. 405.

6 For further development of some of these arguments, as well as the argument that states can conform strategically, see Shanske, “States Can and Should Respond Strategically to Federal Tax Law,” 45 Ohio N.L. Rev. 543 (2019).


Conformity, the TCJA, and the Personal Income Tax

The most significant TCJA changes to the personal income tax were modifications to the rate schedules, personal exemptions, and the standard and itemized deductions. The federal rate changes obviously did not affect states’ rates and many states changed their own laws to offset the revenue-raising effects that the other federal changes would have had on their residents.

During this fiscal emergency, states should be focused on raising revenue from their most fortunate residents to ensure the health, safety, and welfare of the entire community. In that vein, we suggest that states modify their rate structures to make their taxes more progressive rather than tinkering with personal exemptions or standard deductions. That recommendation certainly applies to the nine states that impose flat income taxes. Those states should impose graduated rates, at least for a limited period (for instance, as temporary high-income surcharges).

States that already have graduated rate structures should also look to either add brackets or to raise the tax rates for those in the highest brackets. That recommendation applies especially forcefully for the many states that have graduated structures that are effectively flat. For example, the top bracket in many states kicks in once an individual has under $20,000 of taxable income. Those structures are progressive in name only. And while those states may not be willing to abandon their overall economic or political goals underlying those effectively flat rate structures, they should ask for more from their millionaires than from their entry-level schoolteachers during a global pandemic. High-income taxpayers received the bulk of the tax cuts from the TCJA and have greater capacity to shoulder the state tax burden. Again, at a minimum, temporary surcharges on the highest-income state taxpayers could help state governments endure the coming fiscal storms.

It is worth underscoring here the tautology that an income tax is a tax on income. Suppose someone in the restaurant business earned a high income in tax years 2018 and 2019, and thus profited handsomely from the TCJA. In 2020 this taxpayer earns much less because of the pandemic. Adding a new higher bracket or two will have little or no affect on her while she is down, although she might well need to pay more when her earnings have been restored.

There is also a more direct way to claw back some of the windfall given to high earners by the TCJA: States could affirmatively tax their residents’ “QBI windfalls.” The 20 percent QBI deduction of section 199A was one of the more questionable provisions in the law and served largely to retain a consistent tax rate differential for taxpayers who earned income through investments in C corporations and through passthrough entities. It is unclear, though, why maintaining this arbitrary rate distinction is a preferred policy goal, and in any event, the TCJA did not completely accomplish that goal. The QBI deduction is not available for all taxpayers and is subject to a variety of conditions and phaseouts.

The QBI deduction is also highly regressive. The Joint Committee on Taxation estimated that more than three-fourths of the benefit would go to those earning $200,000 and above. Those with earnings above $1 million received nearly half the benefit. The deduction was therefore not only distortionary, but regressive as well.

13 Shanske, supra note 9, at 487-99.
16 Joint Committee on Taxation, “Tables Related to the Federal Tax System as in Effect 2017 through 2026, Table 3” (Apr. 24, 2018).
17 Id.
Almost no states conformed to the QBI deduction for purposes of their own personal income taxes, and for good reason. The dubious policy reason given for this change at the federal level did not apply at the state level given the lack of state corporate tax rate changes. The states that have not yet decoupled from the section 199A deduction should do so now. We also think that states should go further and affirmatively tax their residents’ QBI windfalls. The section 199A deduction granted those residents savings from paying federal income tax on up to 20 percent of their earnings. That windfall thus increased those residents’ tax-paying capacities and represents a pool of funds that states could access in a progressive way to help the entirety of the state.

Our proposal would not be to tax the QBI benefit retroactively, and so only current and future beneficiaries would pay the tax. Further, we would propose clawing back the benefit only at higher-income levels. Again, the idea is that those who can pay more should pay more in the current emergency, and that in particular, they should pay out of their ill-conceived federal windfall.

Conclusion

State and local governments play a critical role in the health, safety, and welfare of their residents. The pandemic provides a stark reminder that states are on the front lines in the effort to ameliorate human suffering and that their efforts require funding. Strategically rethinking conformity with the revenue-raisers included in the TCJA can form important components of the state government responses, and we thus suggest that states take those steps.

Of course, many will argue that now is not the time to raise taxes on anyone. We are sympathetic with the notion that many are struggling and that, all else being equal, tax increases would be best avoided. Indeed, if the federal government did its job, then additional state-level taxes might not be necessary, even if advisable for other reasons. But all else is not equal. The public health emergency, along with the limited federal response, has created a significant and pressing need for additional state revenue. States must look for ways to raise revenue to ensure both the short- and long-term health and success of their residents. We have suggested some in this article, and states should pay attention to the broader range of proposals being outlined as a part of Project SAFE as they work to address their revenue needs.

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18 Colorado, Idaho, and North Dakota all conform to the federal definition of taxable income and none of those states have decoupled from the section 199A deduction. Also, Iowa affirmatively elected to phase in that deduction in connection with its change in law that will see it conform to federal taxable income instead of adjusted gross income. See 2018 Acts, ch. 1161, section 70.