Conformity and State Income Taxes: Suggestions for the Crisis

David Gamage  
*Indiana University Maurer School of Law, dgamage@indiana.edu*

Michael A. Livingston  
*Rutgers University School of Law - Camden, maliving@camlaw.rutgers.edu*

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Conformity and State Income Taxes: Suggestions for the Crisis

by Michael A. Livingston and David Gamage

Michael A. Livingston is a professor at Rutgers Law School and David Gamage is a professor at Indiana University Maurer School of Law.

In this installment of Academic Perspectives on SALT, the authors explain how and why state governments should evaluate their degree of conformity with federal tax changes.

To guarantee adequate revenue in the post-COVID-19 era, state governments should consider using all possible tools at their disposal. This article explains how and why state governments should evaluate their degree of conformity with federal tax changes in order to achieve this purpose. We recommend that state governments consider:

• Adopting either a static or selective conformity that enables the state to choose the federal tax changes it is adopting, rather than automatically adopting all changes. In most cases, in the current crisis conditions, this should primarily involve accepting revenue-enhancing provisions and rejecting those that reduce revenue.
• Rejecting or postponing conformity to several changes contained in the Coronavirus Aid, Relief, and Economic Security (CARES) Act, including changes to the business interest deduction rules (section 163), net operating losses (section 172), charitable deductions (section 170), and several employer-related provisions, most of which are revenue losers.
• Adopting, if they have not done so already, the revenue-enhancing provisions of the global intangible low-taxed income rules, originally contained in the Tax Cuts and Jobs Act of 2017. (One of us has written on this topic in several prior essays — coauthored with Darien Shanske — so we will not repeat the details of this recommendation here.1)

The remainder of this article provides background and elaboration regarding the suggestions above. This essay is a contribution to Project SAFE: State Action in Fiscal Emergencies.2

General Background Discussion

Conformity relates to state governments’ practice of piggybacking on the federal income tax in designing state-level tax bases. All states with income taxes practice conformity to some degree, but the degree is important, especially in a period of rapid tax changes. When state revenues are in peril, as they are in every state in the COVID-19 era, these differences become especially significant.

One of the principal issues here is the question of static or dynamic conformity. Imagine that the federal government decides that beginning in 2018, previously depreciable expenditures are now currently expensed or depreciated on a faster schedule. A state practicing dynamic conformity would automatically enact the same change for its 2018 returns. By contrast, a state practicing static conformity might say that it conformed to the federal system as of 2015, or even 2000, leaving for itself the choice of whether to enact the

change above. In this example, the state’s revenue would be correspondingly higher.

Of course, when Congress expands the federal tax base, the effect is the opposite. Take, for example, the 2017 GILTI rules, which reduce tax evasion accomplished by transfer of intangibles to low-tax jurisdictions. A state practicing dynamic conformity would most likely put in place a similar rule regarding 2018 returns. But a state that preferred static conformity would not: Unless it enacted new legislation, it would remain tied to old law, and continue to permit the (now federally impermissible) tax evasion. In this case, the static rule would reduce revenue.

A third possibility is for a state to practice selective conformity, adopting only those federal tax changes it wishes to and ignoring the others. This is implicit in the static method described above, but the state may also choose it explicitly.

Like many things in tax — or life — the playing field for state conformity is somewhat arbitrary in practice, reflecting historical circumstance more than a consistent logical pattern. For instance, according to a recent Tax Foundation report, 19 states have adopted static conformity regarding individual tax provisions, 18 have adopted “rolling” (dynamic) conformity, and only four selective conformity, with a handful of states not fitting perfectly into any single category. Since the TCJA broadened the tax base, while reducing tax rates, the rolling or dynamic states (which in theory benefit from base broadening while still setting their own independent tax rates) would in this case come off better than those using a static model. But this conclusion relies on many assumptions, including the effect of the 2017 changes on personal exemptions and the standard deduction (which show up in taxable income but not adjusted gross income) and state conformity to changes in federal business tax provisions.

States using selective conformity would have the best deal of all, assuming that they chose to embrace the revenue-enhancing provisions but not the revenue losers, although this is not always politically possible.

For states seeking new revenues — as many will be in the post-COVID-19 era — it would seem logical to adopt a selective approach (at least for the duration of the crisis), allowing them to follow changes that add revenue and avoid those with the opposite effect. There is admittedly a problem here in that it is hard to predict the nature and extent of federal tax changes. Like states, the federal government faces conflicting pressures, needing revenue enhancers to offset the losses resulting from COVID-19 but at the same time coming under enormous pressure to offer individual and corporate tax relief. A selective approach would allow a state to hedge its bets, metaphorically speaking, rather than adopt all federal changes (dynamic conformity) or presumptively reject them (static conformity).

An especially important element to all this is that state governments face very different policy constraints during economic downturns compared with the federal government. In particular, state governments face balanced budget constraints; they generally have to either raise tax revenues or enact painful spending cuts during economic downturns. By contrast, lacking such constraints, it is often good policy for the federal government to increase deficit spending during economic downturns and to give up tax revenue, thus taking less from private sector actors. Lacking this option, or facing much more stringent constraints on the option to borrow or deficit spend, state governments should generally prioritize raising revenues from economic actors with greater ability to pay (and to endure the economic downturn) over cutting spending programs needed either by those less able to endure the downturn or to minimize damage to state economies.

Consider again a hypothetical federal government shift from depreciation to full expensing. A federal policy change of this sort might well be a prudent federal-level response to

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6 Id.
the economic downturn because it would reduce federal revenue while providing more funds and incentives for private sector businesses engaged in investment. But the downsides of such a policy change would be much higher if applied to state-level income taxes because the state governments cannot so easily deficit spend. This is thus a prime example of the sort of federal policy change that the state governments should probably not conform to during an economic downturn, despite this policy arguably being desirable regarding the federal tax laws.

Some Further Details

An immediate conformity problem presents itself in connection with the CARES Act, enacted this spring. The most visible example concerns the tax status of economic impact payments (EIPs) (“stimulus”) as well as loans provided under the Paycheck Protection Program (PPP) of the Small Business Administration, which help businesses meet payroll in the COVID-19 crisis. Federal law provides that EIPs are tax free and that the cancellation of loans made under the PPP is likewise exempt from tax. It seems unlikely any state would tax EIPs, except perhaps in extraordinary cases. But the PPP rules are a little bit more complex, providing that cancellation of the loans will not be taxable under section 61(a)(12) but lacking clarity about the extent to which related interest payments will be nondeductible under section 265, which prohibits deductions related to tax-exempt income.\(^7\) There may accordingly be room for states to take a more assertive position in this area.

The CARES Act also makes other temporary and permanent amendments to the federal tax laws, including changes to business interest deduction rules (section 163), NOLs (section 172), charitable deductions (section 170), and several employer-related provisions, most of which are (understandably) of a pro-taxpayer, revenue-reducing variety. These provisions put states in a more difficult position, making them appear heartless to taxpayers if they do not conform to the new rules, but further reducing their early shrunken revenues if they don’t. States in need of more revenue should consider rejecting all these changes, particularly as they tend to affect primarily wealthier taxpayers and are likely to be largely invisible to the average voter. Refusing to adopt these changes would appear to involve fewer political risks than, say, a divergence from the PPP rules.