Massachusetts Taxpayers Foundation

TESTIMONY BEFORE THE JOINT COMMITTEE ON REVENUE RELATIVE TO THE FEDERAL TAX CUT AND JOBS ACT.

January 23, 2018

Thank you for inviting me to testify before you today. I am Eileen McAnneny, President of the Massachusetts Taxpayers Foundation. The Foundation is a nonpartisan research organization that focuses on the intersection of state finance, policy and economic growth. Given that, federal tax reform is an issue of great importance to our organization and our members.

I want to start by applauding the committee for holding today's informational hearing. It is important for two reasons. First because it shows that lawmakers are proactively confronting the implications of the Federal *Tax Cuts and Jobs Act (TCJA)*, which will undoubtedly have impacts on both state revenues and taxpayers around the state. In addition, it highlights the importance of gathering as much information as possible before beginning to contemplate specific policy changes. The federal tax bill and its implications are incredibly complex and we, like everyone else, are still sorting through the likely impact. Acting too quickly to make rushed changes to the state tax code could have lasting unintended consequences that should be avoided.

At the Foundation, we are looking at the TCJA through two primary lenses: the likely impact of the federal changes on state revenues; and the impacts on subgroups of taxpayers in Massachusetts– both individuals and corporations – that may warrant state policy changes.

I. DIRECT REVENUE IMPACTS

Before I delve into the substance of my testimony, I want to provide a partial list of the several resources that we have consulted in developing the Foundation's framework for assessing federal tax reform that may be of use to the committee including:

- The National Conference of State Legislatures (NCSL) overview
- The Minnesota Department of Revenue's detailed review of the TCJA which, while not applicable in many cases, provides guidance on the issues to be focusing on;
- The National Association of State Budget Officers review of how differing levels of state tax conformity will affect likely revenue impacts; and
- Our members, especially tax practitioners, that have the practical expertise to think through what the state can expect in terms of revenue changes brought on by this bill.

With respect to the direct state tax revenue impacts, it is too soon to state with certainty what the impacts of federal tax reform will be; however, our initial research indicates that Massachusetts is likely to see a positive revenue impact in the short term. Passage of the federal tax reforms will lead to many taxpayers who had been waiting for federal action to come off of the sidelines and sell capital assets. States are expecting an increase in capital gain tax revenues as a result. In addition, the state's tax base was likely expanded by federal tax reform. The federal approach was to lower federal tax rates, which does not affect Massachusetts, while broadening the tax base, which could impact Massachusetts. Whether or not it actually does depends on whether Massachusetts conforms to the federal tax law with respect to particular IRC provisions.

For example, the newly-enacted provisions like "deemed repatriation" and "the limitation on the carried interest deduction" could provide additional tax revenue for the commonwealth.

With respect to many of the federal changes designed to offset tax increases and therefore reduce tax revenue, Massachusetts has already decoupled from the federal code with respect to many of them, meaning Massachusetts does not automatically adopt them. For example, Massachusetts does not allow accelerated depreciation and therefore does not automatically adhere to changes to that section that will allow for full expensing.

As with all complex laws, much of the guidance will come from regulatory agencies, like the IRS and DOR, and those regulations have not been drafted yet so it is too soon to ascertain the impact.

Longer-term, the Foundation will be focused on the rising federal debt, made higher by federal tax reform, which could constrain federal revenue sharing with the states and push more financial responsibility for programs, such Medicaid and CSR payments and what that means for state financing. That bears close watching.

II. IMPACTS ON TAXPAYERS

The second lens the Foundation is using to review the TCJA is the impact on subgroups of taxpayers. For the majority of individual taxpayers, they should see a reduction in their federal tax liability. I say that because according to the Joint Committee on Taxation, federal tax reform will result in $6 trillion in tax cuts offset by $4.5 trillion in revenue raisers for a net tax reduction of $1.5 trillion over the first ten years of the law's enactment, $1.127 trillion of which will go to individuals and $329.4 billion of which will go to corporate tax cuts.

For individuals:

- The tax rate for six of the seven individual tax brackets were reduced. (for 35% tax bracket the income threshold was reduced to $200,000 from $400,000)
- Child credit was increased from $1,000 to $2,000 and expanded;
- The standard deduction increased from $6,400 to $12,000 for single filers and from $13,000 to $24,000 for joint filers;
- 529 plans can be used for $10,000 in secondary education expenses; and
- The estate tax exemption was doubled to $11.2 million

For the one-third of MA taxpayers who itemize, they will be impacted by the limitation on both the mortgage interest deduction and the State and Local Tax or SALT deduction:

- Some taxpayers will no longer itemize because they will be better off with the increased federal standard deduction;

- For high wealth individuals, however, SALT changes make Massachusetts less competitive than other states with a different tax profile because they would bear the full cost of state and local taxation. Similarly the mortgage interest deduction limitation could exacerbate the high cost of housing here because the cost of financing got more expensive.
- This impact is especially notable given the pending income tax surtax ballot question.

On the corporate side, the 40% permanent reduction in the federal corporate tax rate is expected to result in economic growth and job creation but economists differ on the size, scope and duration of those impacts. However, the elimination of many corporate tax credits and deductions will offset some of the benefit of the corporate rate reduction, impacting various sectors and companies differently and it will take some time to sort out the net effect.

III. RECOMMENDATIONS

In considering how Massachusetts should move forward, the Foundation makes the following recommendations.

We strongly advise against a knee-jerk policy reaction to address an issue raised by federal tax reform that may only create more havoc in the long-run. For example, the creative work-arounds to SALT that some states are considering, such as the charitable contribution in California and the payroll deduction in New York, are far more complicated and potentially problematic from a legal and practical standpoint than they appear at first and we would urge you to proceed with caution. We recommend that the DOR complete the foundational analysis of the impacts of this change for Massachusetts in a timely manner as the requisite first step to policymaking.

At the same time, policy makers must move swiftly to address unintended consequences the TCJA may bring to taxpayers when they come to light. For example, the repatriation of corporate income could adversely impact manufacturers in the state if it means that the total amount of sales for purposes of the sales factor apportionment denominator are vastly inflated and they unable to meet the substantial manufacturing statutory test as a result. Traditional manufacturers could lose the benefits of single sales factor apportionment, the investment tax credit and other such benefits. Some guidance from DOR on how they intend to proceed would be very beneficial for taxpayers who may have to report the uncertain tax position on their financial statements to their detriment.

Determining appropriate policy action – especially in terms of whether or not to conform to the various provisions in federal tax law – is a complicated process that is better to be done thoughtfully and comprehensively rather than quickly. Federal law changes implicate our apportionment rules, combined reporting statute and many other aspects of our corporate tax code. Many of the provisions in the federal law are meant to work in tandem, such as the allowance of full expensing and reduced interest deductibility, and Massachusetts should carefully consider the fiscal and competitive impacts of differing state tax treatment.

The potential impacts of federal tax reform are the latest development in a series of developments that suggest it may be time for policymakers to undertake a more comprehensive review of the Commonwealth's tax code. The migration to online sales threatens our sales tax base; while transportation revenue sources such as the gas tax and motor vehicle excise tax may diminish as new transportation services emerge and the adoption of electronic and autonomous vehicles accelerate.

Today's hearing is a great early step in ensuring that policy-makers, state agencies, research organizations and taxpayers share information and work together to make sure that Massachusetts adopts an approach to federal tax reform that works. The Foundation is committed to being a part of that process and is happy to assist you and your staff in any way you see fit.

Thank you for the opportunity to testify and to answer and questions that Committee members may have.