TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

What switching from FTI to AGI could mean for Colorado

Presentation for the Governor’s Tax Study Group

September 2020 presentation by Tax Policy Center

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The views and opinions expressed in this presentation do not necessarily reflect those of Governor Polis’s administration.

What is tax conformity?

- States conform to federal tax laws by using the IRS code in their tax code
  - Think copy/paste
- Most do this with their definitions of income:
  - Colorado and two other states (ND and SC) use federal taxable income (FTI)
  - 33 states and the District of Columbia use federal adjusted gross income (AGI)
  - 5 states (heavily) use IRS rules and definitions to create their own income definitions
    - *Note: Every state* then *adds and subtracts provisions to create their state taxable income*
- States can also adopt federal credits in their state tax codes
  - e.g., earned income tax credit; child tax credit; child and dependent care credit

First line on Colorado's individual income tax form

Enter the following information from your spouse's current driver license or state identification card.

State of Issue	Last 4 characters of ID number	Date of Issuance

Mailing Address	Phone Number

City	State	Zip Code	Foreign Country (if applicable)

Round To The Neares

1. Enter Federal Taxable Income from your federal income tax form: 1040 line 15 or 1040 SR line 15 ● 1

Include W-2s and 1099s with CO withholding.

Additions to Federal Taxable Income

2. State Addback, enter the state income tax deduction from your federal form 1040 or 1040 SR schedule A, line 5a (see instructions) ● 2

3. Business Interest Expense Deduction Addback (see instructions) ● 3

Starting points for state income taxes

TPC

Standard Deduction — **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness — **You:** ☐ Were born before January 2, 1956 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1956 ☐ Is blind

Dependents (see instructions):

If more than four dependents, see instructions and check here ▶ ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✔ if qualifies for (see instructions): Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Attach Sch. B if required.

1	Wages, salaries, tips, etc. Attach Form(s) W-2				1	
2a	Tax-exempt interest	2a		b Taxable interest	2b	
3a	Qualified dividends	3a		b Ordinary dividends	3b	
4a	IRA distributions	4a		b Taxable amount	4b	
5a	Pensions and annuities	5a		b Taxable amount	5b	
6a	Social security benefits	6a		b Taxable amount	6b	
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐				7	
8	Other income from Schedule 1, line 9				8	
9	Add lines 1, 2b, 3b, 4 … This is your **total income** ▶				9	
10	Adjustments to incom…					
a	From Schedule 1, line …				10a	
b	Charitable contributio… …dard deduction. See instructions				10b	
c	Add lines 10a and 10b. These are your **total adjustments to income** ▶				10c	
11	Subtract line 10c from line 9. This is your **adjusted gross income** ▶				11	
12	**Standard deduction or itemized deductions** (from Schedule A)				12	
13	Qualified business income deduction. Attach Form 8995 or Form 899…				13	
14	Add lines 12 and 13				14	
15	**Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0-				15	

Most states start here (AGI)

Colorado starts here (FTI)

Standard Deduction for—
- Single or Married filing separately, $12,400
- Married filing jointly or Qualifying widow(er), $24,800
- Head of household, $18,650
- If you checked any box under *Standard Deduction*, see instructions.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2020)

Recent federal action and state responses

- Tax Reform Act of 1986 made significant changes to federal AGI
  - Affected nearly all states; accepting broader base increased revenue and many cut tax rates
  - FYI, 1987 is when Colorado begins using FTI
- Most federal tax action for next 30 years changed federal rates and credits—thus, few state issues
- However, TCJA 2017 made significant changes to FTI
  - AGI states mostly unaffected*
  - Colorado and other FTI states saw big changes

**Most states still see revenue gains, but that was from corporate tax base changes* — *Most states still see revenue gains, but that was from corporate tax base changes*

How the Tax Cuts and Jobs Act (TCJA) changed Colorado's income tax

What the TCJA changed in Colorado

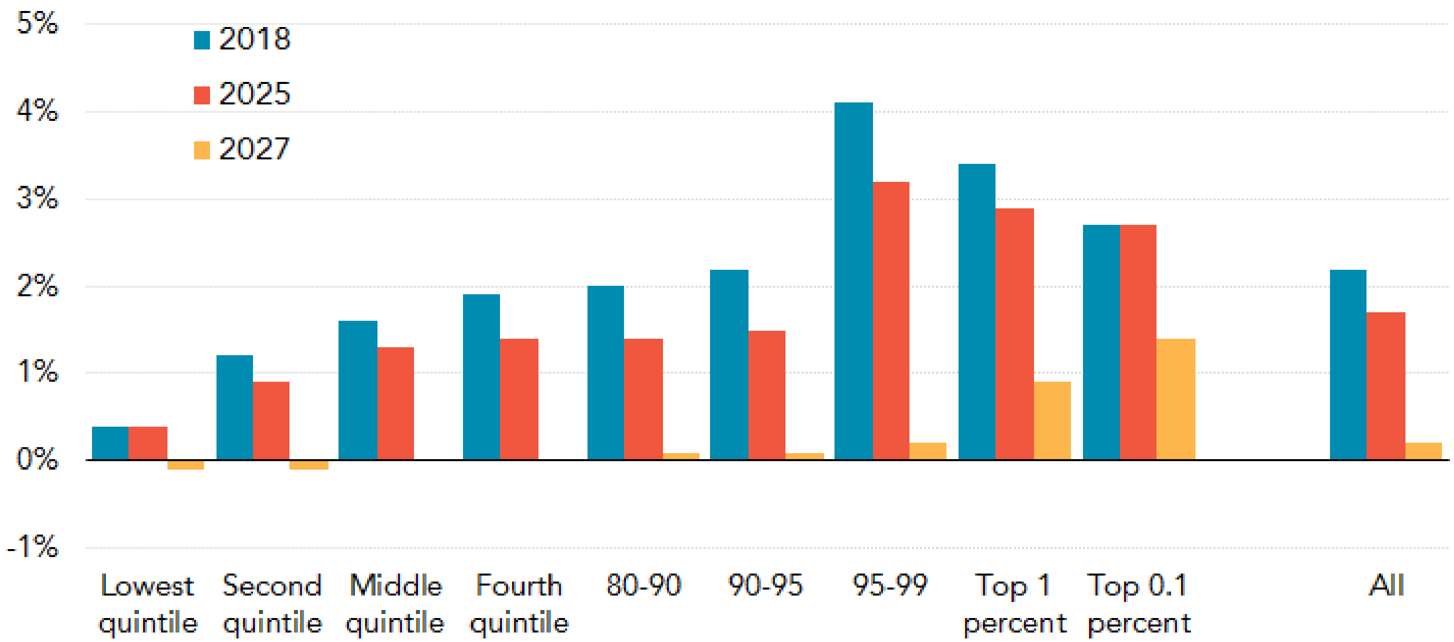
- The standard deduction levels were nearly doubled
  - Single, $6,500 to $12,000; Married, $13,000 to $24,000 (*TY 2018; inflation adjusted*)
- The personal exemption was reduced from $4,050 to $0
  - This was replaced with a larger child tax credit (CTC)
  - *NOTE: Colorado did not conform with the federal CTC until HB21-1311, meaning for state tax purposes many families with children were worse off than pre-TCJA.*
- The state and local tax (SALT) deduction and home mortgage interest deduction were limited; the medical expense deduction was expanded, few other deductions eliminated (e.g., unreimbursed employee expenses)
  - *NOTE: HB21-1327 created an IRS-approved workaround to the SALT deduction that allowed members of pass-through businesses to once again deduct more than $10,000 in business taxes from their federal returns; SALT limit still applies for non-business taxes.*
- The overall limit on itemized deductions ("Pease") was eliminated
  - *NOTE: For state tax purposes HB21-1311 effectively created an income tax limit on overall itemized deduction claims made by taxpayers with AGI >$400k*
- The Qualified Business Income/pass-through deduction was created
- *Note: All of these provisions are set to expire after 2025*

Nationally, the TCJA was a $1.5 trillion+ tax cut

FIGURE 1

Percent Change in After-tax Income of the Conference Agreement for the Tax Cuts and Jobs Act

By expanded cash income percentile, 2018, 2025, and 2027



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1).

NOTE: These estimates include benefits from the corporate income tax changes. That's why some people still get a tax cut in 2027 after the individual provisions expire.

But for Colorado’s state tax, the TJCA caused tax cuts *and* hikes

TPC

What happens to Colorado revenue when the TCJA expires?
Millions of dollars (2018)

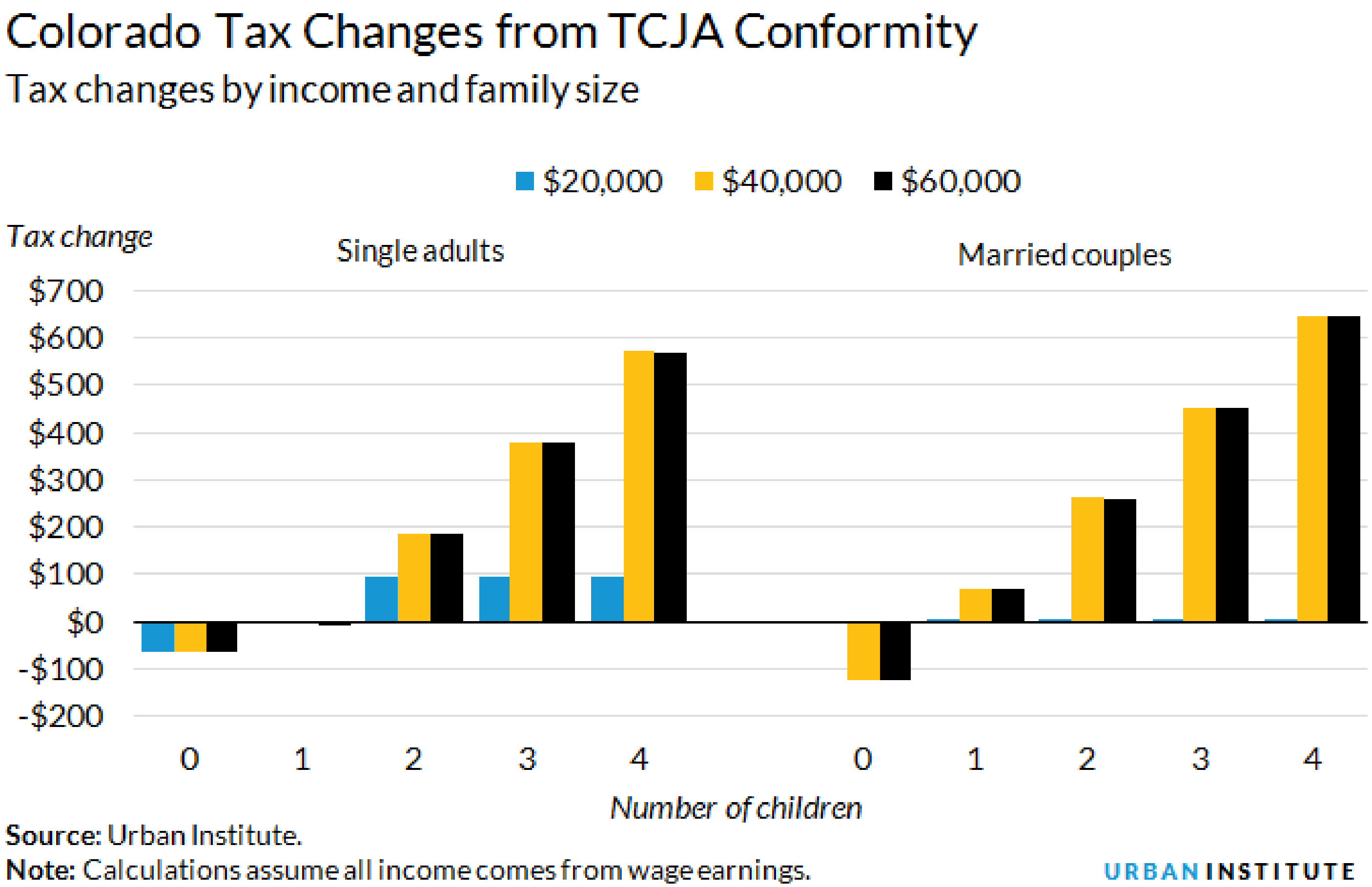
Expired TCJA provision	Effect on CO revenue
Pass-through deduction	$168
Suspended moving expenses deduction	($3)
Increased standard deduction	$734
Suspended personal exemptions	($761)
SALT cap	($11)
Reduced cap on mortgage eligible for mortgage interest deduction	($1)
Suspended miscellaneous itemized deductions	($43)
Suspended Pease limit on itemized deductions	$26
Reduced tax rates	$2
Increased child tax credit	--
Total	**($4)**

Source: Tax Policy Center state income tax model.

Note: Provisions do not sum to total due to interactive effects.

- Table shows revenue change if all TCJA provisions expire
- Flip every number and you see what happened when the TCJA passed
  - *NOTE: Numbers are no longer accurate due to bills passed in 2021 session*
- Overall, the TCJA was roughly a wash for Colorado on the individual income tax
- FYI, corporate tax base broadening raised CO revenue
- But, for individuals, the TCJA raised the Colorado tax or cut the Colorado tax depending on the filer’s characteristics

One loser in Colorado was large families



- Large Colorado families got a tax cut or saw no change at the federal level because of the larger CTC
- But without the CTC in Colorado, losing the personal exemptions led to a Colorado tax hike
- Meanwhile, childless filers got a Colorado tax cut
- *NOTE: Numbers are no longer accurate due to bills passed in 2021 session*

Key takeaways from the TCJA

- The TCJA changes were not necessarily good or bad
  - Some Coloradans got state tax cuts while others got state tax hikes
- <u>But none of these changes were Colorado's choice</u>
  - Would you design a bill that hiked taxes on large families but cut taxes for childless filers?
  - Or a bill that (complexly) cut taxes for (some) filers with pass-through income but increased taxes on those with large property tax payments?
- We know the TCJA expires after 2025 but we have <u>no idea</u> what the next round of federal tax changes will look like and how the federal changes will affect Colorado tax revenue and Colorado taxpayers
  - *NOTE: In the last 20 months we've also seen major federal tax changes from the CARES Act, Consolidated Appropriations Act of 2021, and the American Rescue Plan Act., although most changes happened pre-AGI.*

What would happen if Colorado changed from FTI to AGI?

If Colorado changed to an AGI state ...

- All calculations up to adjusted gross income would remain the same
- But after AGI, Colorado would ...
  - Set new standard deduction amounts (if any)
  - Set new personal exemption amounts (if any)
  - Set new rules for itemized deductions (if any)
  - Lose the pass-through deduction (unless you add it back)
    - *NOTE: HB20-1420 effectively eliminated the deduction for most taxpayers with AGI>$500k (single)/$1M (joint) for Tax Years 2021 and 2022. HB21-1311 extended this means test to Tax Years 2023-2025.*
- Nothing would bind these choices but policy preferences

Standard deductions in AGI states

- 9 states do not offer a standard deduction
- State-specific standard deductions range from $2,500 in Kentucky (same for all filers) to $24,000 in New Mexico (married filers)
  - New Mexico, the District of Columbia, Idaho, and Missouri use AGI as their starting point but then replicate the federal standard deductions (and personal exemptions) on their state tax
- 14 states have standard deductions (married) less than $10,000
- 19 states have standard deductions (married) more than $10,000
- Alabama, Maine, Maryland, Montana, Rhode Island, and Wisconsin phase out their standard deduction based on an AGI calculation

Personal exemptions in AGI states

- 6 states do not offer personal exemptions
  - Some because of conformity (New Mexico); others never offered (Kentucky)
- Personal exemptions range from to $700 in Wisconsin to $6,000 in Mississippi
  - Some states offer the same exemption for the filer, spouse, and dependents (Michigan)
  - Some states offer a higher exemption for the filer than dependents (Massachusetts)
  - Some states offer a higher exemption for dependents than the filer (Georgia) or only offer an exemption for dependents (New York)
- Arizona, Arkansas, California, Delaware, Iowa, Nebraska, and Oregon offer a personal credit (lowers tax liability instead of taxable income) rather than a personal exemption
  - Thus, the amount is typically lower (e.g., $40 in Iowa; $210 in Oregon)
- Alabama and Connecticut adjust their personal exemptions based on AGI

Itemized deductions in AGI states

- 11 states do not offer itemized deductions
- Nearly all of the 29 states with itemized deductions do not allow deductions for state and local income tax (called an “add back”).
- Two other states have similar provisions to itemized deductions, but structure them as credits.
- Many states have some other sort of limitation on their state deductions
  - Total amount is phased-down or phase-out based on AGI
  - Hard cap on itemized deduction amount
  - Limits on specific deductions that go beyond the federal rules
- *NOTE: HB21-1311 requires taxpayers with AGI>$400k to add back to their income itemized deductions that exceed $30k total (single)/$60k total (joint), starting in Tax Year 2022*

Pass-through deductions in AGI states

- AGI states were unaffected by this provision because it applies to FTI
  - Iowa is the only AGI state that added it after the TCJA passed (25% of the federal deduction)
- There are other ways AGI states help pass-through businesses
  - Ohio has a state-specific pass-through deduction (with tighter restrictions)
  - Oregon has different tax rates for pass-through income
- There are other ways to help small businesses
  - Remember, the pass-through deduction was created because the top federal tax rates on individual (37%) and corporate (21%) income were different; Colorado has the same rate
  - If Colorado wants to assist small businesses (regardless of how they file their taxes) there are numerous other ways to achieve this
- *NOTE: Because of HB20-1420 and HB21-1311, Colorado's pass-through deduction is now means-tested to taxpayers with AGI<$500k (single)/$1M (joint) until the end of the TCJA*

Note on estimates

- Large changes to the standard deduction, personal exemption, and itemized deductions are likely to change tax revenue and tax burdens substantially
- Most states undergoing such large reforms also make simultaneous changes to offset tax increases (at least for some taxpayers), including:
  - Rate cuts
  - Increasing the earned income tax credit
    - *NOTE: HB20-1420 increased Colorado's state EITC from 10% of the federal credit, and HB21-1311 increased it further to 20% (25% for Tax Years 2023-2025).*
  - Enacting a child tax credit
    - *NOTE: HB21-1311 activated the dormant state CTC beginning in Tax Year 2022, and doubled it (to keep credit amounts roughly constant) if the federal CTC expansion was allowed to expire.*
- *Note: Provisions listed are for TY 2018; some levels increase annually with inflation*

Other states that recently switched from FTI to AGI: Minnesota and Vermont

Minnesota's rules

- Standard deduction: $12,000 single; $24,000 married
- Personal exemption: $4,050 but only for dependents
- Itemized deductions: Generally follows the federal rules
  - Standard deduction, personal exemption, and itemized deductions are <u>all phased out</u> at roughly $200,000 for singles and $300,000 for married filers

<u>If Colorado used these rules:</u>

- Filers with tax hike: 24%, average $317
- Filers with tax cut: 24%, average $336
- Distribution: tax increases more likely among higher earners
- Revenue: $12 million decrease
- *NOTE: Revenue estimates no longer accurate*

Vermont's rules

- Standard deduction: $6,000 single; $12,000 married
- Personal exemption: $4,150
- Itemized deductions: None; offers a 5% charity credit

If Colorado used these rules:

- Filers with tax hike: 58%, average $355
- Filers with tax cut: 17%, average $203
- Distribution: most income groups see tax increase
- Revenue: $513 million increase
- *NOTE: Revenue estimates no longer accurate*

Caveat

- Not entirely comparable, but both Minnesota and Vermont's departments of revenue have much higher per-capita FTE and appropriation levels than Colorado's DOR
- As a result, it will likely take DOR significantly more time to implement such changes to its tax forms, Gentax programming, taxpayer guidance, rulemaking, and auditing.

Other states with a flat income tax rate: Michigan and North Carolina

Michigan's rules

- Standard deduction: none
- Personal exemption: $4,050
- Itemized deductions: none

<u>If Colorado used these rules:</u>

- Filers with tax hike: 82%, average $617
- Filers with tax cut: 1%, average $147
- Distribution: tax increases likely among all income groups
- Revenue: $1.5 billion increase
- *NOTE: Revenue estimates no longer accurate*

North Carolina's rules

- Standard deduction: $8.750 single; $17,500 married
- Personal exemption: $0 to $2,500 depending on AGI
  - Called a "child deduction" in North Carolina
- Itemized deductions: mortgage interest *plus* property tax deduction capped at $20,000

If Colorado used these rules:

- Filers with tax hike: 74%, average $309
- Filers with tax cut: 2%, average $107
- Distribution: tax increases likely in all income groups but more likely among higher earners
- Revenue: $661 million increase
- *NOTE: Revenue estimates no longer accurate*

How this might possibly work in Colorado

- Colorado switches from FTI to AGI
- Colorado keeps current standard deduction levels or moves to North Carolina's levels
- Colorado increases its EITC by 5 percentage points and adopts a CTC
- Depending on parameters:
  - Total revenue gain ranges from $100 million to $500 million
  - Small fraction get tax increase or majority of filers get tax increase
  - *NOTE: Revenue estimates no longer accurate*
- Higher standard deductions and broader credits make the changes more progressive but reduces revenue gain from FTI-AGI switch
- There are countless ways you can make this work—depends on what you want to achieve

Conclusions

- Even though we're an FTI state, we can always pass legislation after the fact to address certain tax conformity issues, e.g. HB 20-1420, HB21-1311, and HB31-1327 negated some of the effects of the TCJA, though this sometimes makes the tax code more complex.
- Changing from FTI to AGI exchanges simplicity for control
- The latter comes with more decisions, but might result in a better fit for the values and budget of Colorado
- Changing requires the state to make new decisions on the standard deduction, personal exemption, itemized deductions, and pass-through deduction.