Statement of Allen Prohofsky Ph.D., Chief Economist, Franchise Tax Board

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I would like to begin with a few thoughts on conformity. My purpose is to help you develop a framework for evaluating potential tradeoffs between the goals of conformity and other important tax policy goals.

The goal of conformity is to make it easier for taxpayers to comply with tax law and for tax administrators to enforce the law. What do you need to do that? You need to have the information available to know what the tax owed actually is if California is out of conformity. Therefore, we need to think about where the information comes from. What information are we losing because of the federal reform and how difficult would it be to replace this information? Even if you can get the information, how much of a hassle is it for information providers to produce the information and for taxpayers to process the information? Does it make a difference if they are using a CPA or software and how much of a hassle is it for FTB to audit? How much information are we losing because it is area that the IRS is no longer auditing? Then you have to weigh that against all the other important policy goals. Conformity may align or conflict with goals such as revenue goals, perceptions of fairness of the tax code, and economic incentives that you think should or should not be in the tax code. You must weigh these things against one another.

In thinking about conformity, it helps to think about the flow of how you calculate taxes. First you consider all the things that might be counted as income. Some are included and some are excluded. You add up the ones the law says to include. Once you have your income, you subtract all the things the law allows as deductions and what’s left is taxable income. Then you apply tax rates and credits to calculate tax. In general, it is harder to be out of conformity on calculations of income and sometimes on deductions. It is relatively easy to be out of conformity on the calculation of tax. Calculation of tax applies tax rates and credits. Few word argue that if you are in a 25% federal tax bracket you should also be in a 25% state tax bracket, so we likely want to be out of conformity there.

The key issue with nonconformity is that it’s a lot easier if the necessary information is available on the federal return. Let’s walk through a couple of examples. I will start with a relatively obscure one, not particularly important in terms of the number of taxpayers or amount of money involved, but good for illustrating information issues. There was a provision that is being removed from federal law that excluded from income certain payments made to bicycle commuters. Whether or not it is hard for California to conform depends on how this income is treated. In a perfect world for nonconformity, employers would be given instructions to report commute incentive payments separately from wages. Then the federal return would have a line to enter the incentive payments and instructions to add these payments to income. That’s not going to happen because this item is not important enough to put a new line on the federal form to cover this item for only a few people. There are two ways it could come in. If we are lucky, they will include this income in your taxable wages on your W-2 and there will be a box somewhere else on the W-2 for which they will create a new code that identifies the amount included in wages that is from commute incentive payments. If we have good information reporting systems, we could then find that code and make an adjustment to California income based on the amount reported for that incentive. If these payments are included in reported wages without a separate code to identify them, it will be difficult for taxpayers to know how much income can still be excluded under California law and for us to know if they are reporting the right amount. This is an area that, depending on how the information flow is implemented, there may or may not be a powerful administrative argument for conformity.

Another example that has several layers to ponder is the change in the treatment of alimony. Under prior federal and current California law alimony payments are deducted by the payer and included in income by the recipient.   This is no longer the case for federal purposes for agreements after a certain date. There will be issues in the short run because the IRS will have to keep the lines for the deduction and inclusion on the return for those with older alimony agreements. Some taxpayers will be using the old system and some will be using the new system so there may be some confusion. Again, you have to ask the question for people who aren't using the old adjustments for their federal returns, where is the information going to come from? How is the state going to know? Also, what if one taxpayer who knows the law and one who does not? The payer may deduct the income while the recipient does not include it.   Or the opposite problem may arise where the income is included by both parties. We don't want either of those outcomes. It is more challenging to educate taxpayers when the rules are different for state and federal purposes.

Another interesting feature of this conformity decision is that, even though amount of combined income being reported by the two taxpayers involved is the same under either option, there is a revenue impact. Why? Because people who pay alimony tend to be in higher tax brackets than people who receive it. We estimate that if these payments had been treated as income of the payer instead of the recipient in 2015, it would have raised California revenue by about $150 million. A subtle point here is that, presumably, in future alimony agreements the amount of money being paid will be reduced a little bit relative to what it would have been under prior federal law to reflect the change in tax treatment. Even if California does not conform, there will still be a tiny revenue gain to the extent that more of the income is taxed on the payer side. This also reduces the revenue gain that would be attributed to California conforming to the new provisions.

While nonconformity can cause many complications, there are areas where it is less of a problem. From an administrative perspective, as long as the necessary information is on the federal return it's easy mechanically to be out of conformity. For example, lottery income is included on the federal side but is excluded for California purposes. It is easy to make that adjustment by subtracting the amount reported on the federal return. Health Savings Accounts and educator expenses are deductions available on the federal side but not the state side. Again, it is mechanically easy to make those adjustments because we know where the information on the federal return and can add the amounts back on the California return.

As noted earlier, on tax rates there is no need to conform. There is also no need to conform to provisions granting special tax rates to certain types of income. For example, California is not currently conforming to the special tax rates on qualified capital gains and dividends. In fact, mechanically it is in some ways easier to not go through the extra calculation required at the federal level. Similarly, conformity is not a reason to adopt special tax rates for the pass-through incomes like the federal government has just done. Such a decision should be based on other policy considerations.

I would also like to say a few words about revenues. I do not have all the answers that I know everyone is waiting for, but I do want to highlight some of the issues that we are facing in developing revenue estimates related to this policy change. Revenue estimates are based on both the data we have available and on assumptions about how things may change in response to policy changes. There is a huge lag in actual data. When will we actually know what people reported on their 2018 return? Tax year 2018 return is filed in April of 2019 and the interesting returns will come in on extension in October 2019. Sometime at the end of 2019 we will really know what the responses to the new policy were. On the corporate side it's even worse. Corporations that can file on a fiscal year basis so receiving that data may be delayed by almost an entire year. It will be close to the end of 2020 before we have complete data on the 2018 tax year.

The lack of data makes revenue estimates the most uncertain in areas where we expect the biggest behavioral responses. We are not as good at predicting how effective new or altered incentives will be. Let me give you some examples. One is the question of what types of business entities will we even be seeing. This bill has competing incentives. It lowers the corporate tax rate which will cause more entities to become corporations, and it provides the new deduction for pass-through entitles which will cause fewer entities to become C-corporations. I don't even know which direction the ultimate behavioral response is going to be, which makes it very hard to model what the ultimate revenue outcome will be.

Once new rules are in place, taxpayers will think about how they can use the new rules in a way that is still legal but works to their advantage. For example, suppose you have a taxpayer filing a joint return that is at the $10,000 limit for state and local tax deductions, has $5,000 a year in mortgage interest, and is making about $10,000 a year in charitable contributions. That adds up to $25,000 which is more than the new standard deduction of $24,000, so they will still itemize their deductions. Over a two year period they will taking $50,000 in deductions. What if instead of doing that they skip their charitable donations every other year and donate twice as much every other year. Over the two year period they are still holding the charity harmless but now in year one they have $15,000 in deductions, they will take the $24,000 standard deduction. In year two they will claim $20,000 in charitable deductions and have total deductions of $35,000. So over the two year period they have $9,000 more in deductions and a significant federal tax savings. How many people are going to do things like that? I don't know, but I will in a few years when we get the data.

Another example of revenue estimates that are sensitive to behavioral responses that we are unsure about can be found in the new repatriation provisions for the corporate tax. The new federal law has some provisions where there are deemed dividends. Some of the money corporations have offshore is being included in federal income even if it is not actually brought back to the US. California law might not treat these deemed dividends the same way. California does tax the money when it is repatriated, which may or may not be at the same time as the deemed dividends. Even if we know how much the federal revenue estimate is for the deemed dividends, not all of that money necessarily flows through. The second issue is there are some of these amounts that California is not going to tax. Companies can elect to file on a worldwide or water's-edge basis. This provision should not affect worldwide filers, so we need to figure out which taxpayers are filling on each basis. We have to hope that taxpayers aren't switching in response to the law change. We saw this before when we tried to do estimates on Proposition 39. One of the issues that threw off that revenue estimate was we mis-guessed about a couple of taxpayers that changed their election at the time the sales factor election became available. That caused an error in our estimates. Another complication is that there are dividend received deduction provisions in California law, so even if the money is being repatriated by a water's-edge taxpayer it doesn't necessarily all go into taxable income. We also have to think through whether any of these things changes taxpayer's apportionment factors and how that might impact revenue. Furthermore, it matters whether taxpayers with high or low apportionment factors are the ones that repatriate. We also have a provision that that certain controlled foreign corporations in high tax jurisdictions can be carved out of the water's-edge. The definition of high tax jurisdiction is keyed to the federal corporate tax rate. When the federal corporate tax rate goes down, the number of foreign entities in jurisdictions that qualify for the election not to be included in the water's edge goes up. We don't know how many of these entities are out there and how many will make this election. We can, however, assume if they do make this election it will probably reduce California revenues. The final consideration on the back end is that at least a portion of the money we get from repatriation will be a time shifting of revenue not a permanent increase because there will be a reduction in future revenues whenever the money would have been repatriated if federal law had not changed.

In conclusion, we will soon provide revenue estimates for potential conformity to many of the provisions of this complex change in federal tax law, but, for the reasons described above, these estimates will not be as precise as we would like them to be.