Interacting Federal and State Taxes

The Impact on State Tax Systems of Replacing the Personal Income Tax With an Expenditure Tax

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Tax policy specialists have long debated the merits of replacing the personal income tax (IT) with any of several versions of a progressive tax on consumer expenditures. Many of the design details of the expenditure tax alternatives have been carefully worked out. However, there has been little discussion of possible impacts of this proposed tax reform on state tax systems and how these might influence both the appropriate design of the federal tax reform and its desirability. This paper attempts to begin to fill that gap.

Versions of Expenditure Taxation

Two proposals that have received the most attention in recent years are the personal expenditure tax (ET) and the X-Tax. The ET is the purest version of progressive expenditure taxation; the X-Tax is less pure but simpler.

The ET base starts with federal taxable income, adds purchases of assets and repayment of debt, and subtracts sales of assets and borrowing to achieve a tax base equal to each taxpaying unit's consumer expenditures. It then applies a progressive tax rate schedule to this tax base, reduced by whatever personal deductions are allowed. Important design details include the following:

- Will transition relief be provided to prevent or at least limit double taxation of consumption funded by assets accumulated out of income previously subject to the IT? This relief would take the form of deduction of the tax basis of assets owned on the date the tax takes effect, presumably over a period of time. However, it may be difficult to limit such relief to assets accumulated from after-tax income, such as by excluding inherited assets to the extent there was a step-up in basis at death.

- Sales of assets previously received by the taxpayer through gifts or bequests would be included in the ET tax base. Should gifts and bequests also be treated as consumption of the donor/decedent? Absent such double taxation of gifts and bequests, replicating the progressivity of the existing personal income tax at the highest income levels may require very high tax rates.[1]
- Should state and local personal income or expenditure taxes be deductible in computing the federal ET base? This issue is discussed further below.
- Should there be some form of corporate tax? The logic of the ET suggests that there is no need for an entity level tax on corporations because corporations do not engage in consumer spending; however, some versions of the ET maintain some type of entity-level corporate tax either because the drafters cannot face the political implications of repealing the corporate income tax or because they wish to maintain the revenue from a source-based tax whose burden is seen as falling on foreign owners of U.S. corporations.

The X-Tax is an attempt to avoid the complexities associated with the ET's treatment of asset transactions and borrowing. It consists of a progressive personal tax on wage and salary income coupled with an accounts-based (or, alternatively, subtraction method) value added tax (VAT) on businesses with a deduction for wage and salary expense and a tax rate equal to the top wage and salary tax rate. In contrast to a more conventional VAT, which is effectively a flat-rate tax on consumer spending, the X-Tax shifts the taxation of wage and salary income from businesses, who are assumed to pass any tax through as higher prices, to workers, making feasible the tailoring of tax burdens on wage and salary income to the personal circumstances of the worker's taxpaying unit. Important design details include the following:

- Should the VAT and the wage and salary tax have deductions for state and local taxes? Should relief be given to state and local governments for the additional burden they will bear as their contractors and suppliers pass through the VAT to them as higher prices for goods and services?
- Should the VAT include border tax adjustments; that is, should it be imposed on imports and should a rebate be given to exports?
- Should transition relief be given to assets in place when the tax is enacted? This would take the form of continuing cost recovery for these assets as if the income tax had remained in place. Compared with the ET, the transition issue under the X-Tax is less salient because it takes the form of price increases and declines in asset values rather than outright double taxation.
- Should the tax administrator require reporting of income other than wages and salaries, presumably including information reporting by payors, for use in administering means-tested income maintenance programs, which would continue to be based on net income, not just wage and salary income? If so, what efforts would be made to achieve compliance with these requirements, especially at upper-income levels where precision is probably unnecessary for proper administration of income maintenance programs?

Potential impacts on state tax systems

The impact of the federal tax system on state systems arises primarily from two sources. First, states derive significant benefits from conforming to data elements on federal tax returns, so that the presence or absence of these data elements constrains states' ability to structure their tax systems. Second, the federal tax structure provides incentives to states to structure their tax systems in particular ways.

No state conforms precisely to the federal income tax in the sense that it uses federal taxable income as its tax base;[2] however, all states with income taxes use federal data elements as the starting point for the tax base calculation. Conformity makes compliance easier for taxpayers, who have presumably completed a federal tax return before they fill out their state tax returns, and it allows the states to piggyback on the Internal Revenue Service's enforcement efforts through data exchange. In the absence of any formal process by which states can achieve interstate conformity among their tax laws, the existence of a federal tax base also provides a focal point for states to coordinate their own laws to the extent that federal conformity becomes a norm among the states.

The incentives provided by the federal tax system arise from the presence or absence of deductibility of state taxes in computing the federal tax base, federal tax rates, and any credits provided for state taxes against federal taxes. Federal deductions or credits for certain kinds of state taxes encourage states to use those taxes. Conversely, in the absence of deductibility, a high federal tax rate on a particular tax base discourages states from using that base because even a small state tax can represent a very large fraction of the taxpayer's income or expenditure after federal taxes and thus provide a strong incentive taxpayers to change residence to a lower-tax state or engage in other actions to reduce the tax base. A high federal tax rate also imposes a practical cap on state tax rates owing to the obvious undesirability of combined federal-state tax inclusive tax rates approaching or exceeding 100%.

One might expect states to be concerned if the federal tax reform either makes infeasible or penalizes the use of tax bases which are disproportionately concentrated in their state or on which they have chosen to rely as a policy matter. Conversely, taxpayers may be concerned if the federal tax reform leads states to adopt tax systems that do not coordinate with each other, leading to double taxation, or if it encourages states to extend the reach of their tax systems into tax bases they have historically not exploited.

State response to a federal personal expenditure tax

A federal ET return would contain all the data elements needed for computation of either a state ET or a state IT, so there would not appear to be a technical barrier to states' either conforming to the ET base or retaining the IT base. However, the very high federal tax rate on upper-income taxpayers that may be needed to maintain the existing level of progressivity in a federal ET would elevate coordination between federal and state tax systems into a key issue. Coordination involves both the rate structures and whether the federal tax provides a deduction or credit for the state tax.

There does not appear to be a perfect answer here. Deductibility of state taxes against a very high federal tax rate would provide very generous *de facto* revenue sharing with states and a powerful incentive for them to impose high personal taxes on the upper-income taxpayers subject to the high federal rate. However, as discussed above, non-deductibility severely compromises states' ability to impose IT or ET on upper-income taxpayers if the federal ET rate is very high. Proponents of a federal ET to replace the IT frequently dismiss the concern that the this tax reform would be regressive by noting that the problem gets resolved merely by setting ET rates at appropriately high levels; however, unless the ET contains a deduction for state taxes, the requisite high federal ET rates may well preclude states' maintaining the existing level of progressivity of their tax systems. One answer might be either partial deductibility for state taxes.

It is tempting to minimize the adverse impact of compromising states' ability to maintain existing levels of progressivity because the issue only arises for the highest income taxpayers presumed to have high savings rates and therefore presumed to be subject to very high tax rates under a federal ET that maintains the existing level of progressivity. However, several states are heavily dependent on revenues from just these upper-income taxpayers. New York State, for example, raises 54% of its revenue from the personal income tax, almost 35% of which was paid by taxpayers with adjusted gross income over $1 million in 2010.[3] California (49% of revenue from income tax, 30% paid by millionaires in 2011) and New Jersey (40% and 26%, respectively in 2011) are other states with high dependence on upper income taxpayers.[4] A federal ET without deductibility, which compromises these states' ability to impose these taxes, is likely to be highly problematical for these states. Conversely, if state taxes are made deductible against very high federal tax rates, states like Texas and Florida with high concentrations of upper-income taxpayers might be tempted to abandon their historic aversion to progressive personal taxation. Either way, the state response to a high-rate federal ET is likely to significantly affect its distributional impact in a number of large states and make it difficult to determine how to achieve distributional neutrality, much less to actually do so.

A second problem for states with the ET arises if the federal corporate income tax is repealed in connection with adoption of the ET. This would severely compromise states' ability to maintain a tax on corporate net income, raising the questions of whether states would abandon any attempt to impose an accounts-based tax on corporations or, if not, how they would structure such a tax.

The corporate tax represented only 5.3% of state revenue in 2012, so that one might think that states could adjust to the loss of this revenue source with only modest adjustments to other taxes.[5] This sanguine view is likely to be mistaken. First, some states rely on corporate taxation much more heavily than the national average, led by New Hampshire with a corporate tax share of 23.6%. Second, the corporate tax is viewed, rightly or wrongly, as a tax whose burden is largely exported to residents of other states, which provides a political incentive for states to preserve some form of corporate taxation. If they lack the capacity to tax corporate net income, states are likely to migrate to less desirable but more easily administered corporate tax bases, such as cascading gross receipts taxes.[6]

Because the federal ET would enable the states to retain the technical ability either to conform to the ET base or retain the IT base, the possibility exists that states would split between these alternatives unless the federal law contained incentives pushing the states in a particular direction, such as deductibility for the ET but not the IT. Inconsistent state responses would lead to double taxation of the savings of taxpayers who earn income in an income tax state, save out of this after-tax income, and retire and spend those savings in an ET state. Taxpayers with the opposite fact pattern would receive unwarranted tax benefits. If the motive of replacing the federal IT with an ET is to encourage saving, this objective is undercut to the extent that states double-tax the saving.

States that do conform to the ET will have to decide whether to adopt a pure residence-based approach or to continue the income tax practice of imposing tax based on source with resident credits for tax paid to other states. Cosmetically, an ET looks like it should be a residence-based tax because taxpayers typically consume at their place of residence; however, it is unlikely that states relying heavily on income tax revenue from non-residents, like New York (17% of income tax revenue in 2011), will easily give up this tax base.[7] Selective adoption of residence taxation produces another source of double taxation because states adopting residence-based taxation are unlikely to give credit for taxes paid to source states.

Similarly, states may be reluctant to provide transition relief for pre-existing tax basis in situations when the previous income tax may have been paid to another state.

In sum, replacing the federal IT with an ET raises a variety of issues for states. It may be difficult for both the federal and state governments to preserve distributional neutrality, inconsistent state conformity may lead to double taxation, and states may be led to move to lower-quality corporate tax bases. These issues are mitigated to a certain extent if the federal corporate income tax is retained, if the federal ET involves sufficiently low tax rates, and if state taxes are deductible in computing the federal ET base.

State response to a federal X-Tax

Because the personal tax base under the X-Tax is limited to wage and salary income, it is problematical whether it would be feasible for states to retain a personal income tax on other sources of income. If the Internal Revenue Service requires income reporting to produce data for use in administering means-tested income maintenance programs, together with the requisite third-party information reporting systems, states may be able to continue broad-based personal income taxation; however, in the absence of a vigorous federal enforcement effort, one would expect a deterioration in compliance with respect to income and deductions for which there is no third-party information reporting. Larger states would find it easier to compensate for the lack of federal enforcement than would smaller states.

In contrast, the accounts-based VAT on businesses would contain the data elements necessary for states to continue to tax corporations on their net income or to conform to the new federal business tax base. Because the business tax base under the X-Tax is so much broader than net income, one might expect states to give serious consideration to conforming, especially if they forego broad-based personal income taxation. However, there is no particular reason to assume they will conform precisely to the federal model. States, for example, have been reluctant in recent years to conform to federal enactments of accelerated depreciation and might similarly resist the expensing of investments in the X-Tax.[8]

The X-Tax's shifting of the tax on income other than wages and salaries from the individual to businesses might be viewed as a minor event for federal tax purposes, the principal substantive changes being that this income is taxed at the top tax rate even if earned by persons who do not have high incomes and that the X-Tax contains no explicit capital gains tax. However, these changes are not necessarily minor events for state taxation because states apportion business income very differently than personal income, some exploit the business and personal tax bases very differently, and some rely heavily on capital gains taxation.[9]

For wage and salary income and income earned in a trade or business, states generally impose personal income tax on a source basis, with the state of residence also imposing tax and crediting tax paid to the source state. For personal income tax, most income from a trade or business is typically sourced on an origin basis, although California has recently adopted a destination sourcing rule for this income. For income from intangibles, states impose tax on a residence basis. For state tax on corporations, income is apportioned, and a norm is rapidly developing to calculate apportionment using a single sales factor and a destination sourcing rule.

Therefore, if a state conforms to the X-Tax and apportions business income using a destination-based single sales factor, three things happen: (1) It retains its existing tax base on wages and salaries; (2) except for California, it replaces origin sourcing of most income from a trade or business with destination sourcing, and (3) for income from intangibles, it replaces existing residence taxation with taxation using destination sourcing based on the sales of the business that pays the income on the intangible (because the business is not deducting the payment and is apportioning its tax base on a destination basis).

A rough cut at analyzing the magnitude of these changes can be made by assuming that a particular state's share of the tax base under destination sourcing is approximated by a state's share of adjusted gross income. For most states that impose both personal and corporate net income taxes, conformity to a X-Tax base does not appear to cause a significant change in the size of its overall tax base. For most states, the share of adjusted gross income (the share of the tax base under destination sourcing) is approximately equal to its residents' share of non-wage income (that is, its share of the tax base under the personal income tax). However, for a few states, there will be significant changes. Florida, for example, does not tax personal income but would experience the benefit of a larger business tax base if it conforms to the VAT under the X-Tax. As is the case with the ET, New York would lose a significant share of its upper-income tax base because its share of the nation's non-wage income received by millionaires (13.7% in 2010) greatly exceeds its share of AGI (7.7%). Connecticut would be similarly affected (2.9% of non-wage AGI received by millionaires compared to 1.7% of AGI). California would experience a less extreme but noticeable reduction in its upper-income tax base (15% of non-wage AGI received by millionaires compared to 12.0% of AGI).[10]

In light of these states' dependence on revenue from high-income taxpayers, they may react to the X-Tax by retaining residence-based taxation on non-wage income, at least on these taxpayers.

The possibility, therefore, exists that enacting the X-Tax at the federal level will lead to an increase in state taxation of income from capital as states like Florida accept the expansion of the tax base while states like New York and California attempt to retain their shares of the existing tax base. However, it is also possible that states will be forced to abandon personal income taxation entirely, creating issues for those states like New York and New Jersey that have been exploiting the tax base provided by upper-income taxpayers or non-residents to fund expenditures that benefit the population at large.

Conclusion

Federal enactment of either an ET or an X-Tax would likely to produce changes in state taxation that many will view as unfavorable and that, to some extent, would undercut the principal objective of the federal tax reform, which is generally seen as reducing taxation of capital. If someone were on the fence about the federal tax reform prior to considering its impact on state tax systems, he or she would probably decide against reform afterwards. It is hard to say which of the two alternatives produces a better answer at the state level and, therefore, one's view as to which of them is preferable. That would depend on the design details of each proposal. However, the problems with the ET seem more easily resolvable than do those with the X-Tax.

1 Unfortunately, little data are available on savings rates of very high-income taxpayers. Assuming a savings rate as high as 50% for this group, a tax-inclusive ET rate of approximately 80% would be needed to maintain the progressivity associated with a 40% federal income tax rate.
2 Indeed, federal law precludes states from using federal taxable income as their tax base by pre-empting states' ability to tax certain kinds of income, such as interest on Treasury securities. These federal pre-emptions would have to be reconsidered if Congress replaced the IT with an ET.
3 For New York these data are available at New York State Department of Taxation and Finance, Analysis of 2010 Personal Income Tax Returns, Table 20, available at http://www.tax.ny.gov/pdf/stats/stat_pit/pit/analysis_of_2010_personal_income_tax_returns.pdf.
4 For California, data on the distribution of tax liability are in California Franchise Tax Board, Annual Report 2012, Table B-3, available at https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/2012.shtml. For New Jersey, these data are available in State of New Jersey, Department of the Treasury, Division of Taxation, Statistics of Income 2011 Individual Income Tax Returns, Table 4.3a, available at http://www.state.nj.us/treasury/taxation/pdf/pubs/soi_tables2011.pdf.
5 Federation of Tax Administrators, available at http://www.taxadmin.org/fta/rate/12taxdis.html.
6 Ohio currently imposes a gross receipts tax in lieu of a corporate income tax.
7 New York State Division of the Budget, Economic and Revenue Outlook, January 2014, p. 170.
8 Less than one-third of states with corporate income taxes conform to federal bonus depreciation. Because states must balance their budgets annually, they are typically less enthusiastic than the federal government about tax incentives that take the form of tax deferrals.
9 For example, between 2007 and 2011, in New York State the share of adjusted gross income accounted for by net capital gains fluctuated between 5% and 16% and is expected to average approximately 10% going forward. Because capital gains are taxed at relatively high marginal tax rates, the share of personal income tax liability arising from capital gains is higher. See New York State Division of the Budget, Economic and Revenue Outlook, January 2014, p. 172.
10 Internal Revenue Service, Statistics of Income, 2011, available at http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2.