

STATE INDIVIDUAL INCOME TAX CONFORMITY IN PRACTICE: EVIDENCE FROM THE TAX CUTS & JOBS ACT

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Nearly every state incorporates the federal tax code into its individual income tax system. This widespread incorporation has many supporters and has been justified on the basis that it is necessary in order for states to have a simple and efficient tax system. This article explores the practical effects and dynamics of state tax conformity through a novel examination of how states that tightly conformed to the federal individual income tax responded to the recently enacted Tax Cuts and Jobs Act which, for these states, would have both raised state taxes and changed the distribution of state tax burdens. The study reinforces concerns raised in both the theoretical and economic literature regarding conformity's enhancement of revenue volatility and likelihood of distorting state legislative decision-making, while adding several new observations of conformity's impact. The study illustrates that conformity imposes significant time constraints on state legislatures, conformity causes not only revenue shocks, but tax policy shocks, and even where state revenue is kept constant following a federal change, conformity may cause relative state tax burdens to change. Based on these findings, the article concludes by offering suggestions for how states can move past the idea that extensive conformity with the federal tax code is required and instead design an individual income tax system that is simple, efficient, and enhances a citizen's relationship to the state.

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INTRODUCTION

State income taxes are of critical importance to ordinary citizens in the forty-one states that impose them. Such taxes fund a significant portion of essential governmental services,¹ directly impact take-home pay of workers, and involve one of the most significant interactions citizens have with their state government. Yet, despite this central importance, most states tie their individual income tax to the widely-criticized federal income tax code,² a system that has been characterized by a bipartisan study^{as} “fundamentally unfair, far too complex, and long overdue for sweeping reform.”³

While many scholars acknowledge that there are trade-offs involved in state incorporation of federal tax law, commonly referred to as state tax conformity, the practice enjoys widespread support.⁴ There are many arguments made in its favor. Conformity is thought to greatly simplify recordkeeping and return preparation for taxpayers, who only need to learn one set of rules. It is also thought to make enforcement of state tax laws much more efficient, since states can rely on federal tax guidance and audits when enforcing their own tax laws. Another common argument is that conformity conserves state legislative resources by outsourcing tax design to the federal government. Indeed, some have argued that conformity should be required,⁵ while others simply argue that conformity should be encouraged and increased.⁶

¹ The individual income tax is in fact a much more important revenue source for states than the corporate income tax. State individual income taxes are nearly forty percent of all state tax collections, while state corporate income taxes account for only five percent of such collections. U.S. CENSUS BUREAU, STATE & LOCAL GOVERNMENT FINANCE, FISCAL YEAR 2016 (2019), <https://www.census.gov/data/datasets/2016/econ/local/public-use-datasets.html> [perma.cc/HVJ9-5G4P] (percentages calculated by author).

² See, e.g., Richard L. Doerenberg & Fred S. McChesney, *Doing Good or Doing Well? Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891 (1987); Mary Louise Fellows, *Rocking the Tax Code: A Case Study of Employment-Related Child-Care Expenditures*, 10 YALE J. L. & FEMINISM 307 (1998); Kristin E. Hickman, *Pursing a Single Mission (or Something Closer to It) for the IRS*, 7 COLUM. J. TAX L. 169 (2016); Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic Of Collective Action*, 84 N.C. L. REV. 1159 (2006); Julie Roin, *United They Stand, Divided They Fall: Public Choice Theory & The Tax Code*, 74 CORNELL L. REV. 62 (1988);
³ NAT’L COMMISSION ON FISCAL RESP. & REFORM, THE MOMENT OF TRUTH 24 (2010).

⁴ See, e.g., Heather M. Field, *Binding Choices: Tax Elections & Federal/State Conformity*, 32 VA. TAX REV. 527, 539 (2013); Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE L.J. 1267, 1267–68 (2013) (noting that “the administrative and compliance advantages of federal-state tax-base conformity are so significant that states are unlikely to abandon it”); Kirk J. Stark, *The Federal Role in State Tax Reform*, 30 VA. TAX REV. 407, 423 (2010) (“The availability of the federal income tax base as a starting point in calculating state tax liability is an unqualified benefit”).

⁵ Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 897 (1992) (“I urge that Congress require the states to use partly or wholly uniform tax bases for business and perhaps personal income taxes”).

⁶ See, e.g., Harley Duncan & LeAnn Luna, *Lending a Helping Hand: Two Governments Can Work Together*, 60 Nat’l Tax J. 663 (2007); Jared Walczak, *Toward a State of Conformity: State Tax Codes a Year After Federal Tax Reform*, TAX FOUND., FISCAL FACT NO. 631, Jan. 2019, at 42.

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Despite relatively widespread support for conformity, prior literature has also examined the detriments of conformity. Conformity increases the volatility of state income tax revenue by subjecting it to exogenous shocks triggered by federal tax changes.⁷ Conformity not only introduces these exogenous shocks, but it also may skew legislative decision-making in response to such shocks.⁸ States are about evenly split in whether they dynamically conform to federal tax law, or whether they use static conformity. In dynamic conformity states, federal tax changes automatically take effect without legislative action. Static conformity states, on the other hand, remain tied to prior federal law unless the legislature votes in favor of a statutory amendment. A state legislator in a static conformity state may be unwilling to affirmatively vote to conform to federal changes where doing so would raise state taxes. But a legislator in a dynamic conformity state might be perfectly willing to do nothing and allow a stealth tax increase to take effect.

In part because of these exogenous revenue effects and unique decision-making dynamics, economists and political scientists have long been interested in state tax conformity. Yet nearly all such empirical studies have focused exclusively on the state corporate tax—a tax that is much more complicated and much less fiscally important to most states than the individual income tax. Those studies' findings are not terribly encouraging. They have found little rhyme or reason to what drives state legislative decisions to either conform or decouple from specific federal tax provisions.⁹ But they have found that, where federal tax changes increased state taxes, state legislators did not take action to fully reverse those tax increases.¹⁰ In other words, states allowed an exogenous federal change to increase the taxes its citizens pay – an irrational result if legislators had already determined their optimal mix of taxes and spending.

This article uses the recently-enacted Tax Cuts and Jobs Act (the “TCJA”) to explore how state tax conformity operates in the real world. It provides a novel examination of how states with the tightest conformity to federal tax law responded to the fundamental changes in the federal individual income tax structure enacted by the TCJA in 2017. In each of these states, state taxes would have significantly increased if the state remained in tight conformity with federal law and made no offsetting state tax changes. In addition, the relative distribution of those tax burdens would have shifted because the federal law eliminated the previous adjustment for family size and provided a significant deduction for some forms of business income. As a result, the 2017 federal changes provide an excellent opportunity for a real world look at how conformity affects state individual income tax systems.

⁷ Stark, *supra* note 4, at 424-25.

⁸ Mason, *supra* note 4, at 1325-28.

⁹ See *infra* [Part II.B.i.](#)

¹⁰ Steven D. Gold, *The State Government Response to Federal Income Tax Reform: Indications from the States that Completed Their Work Early*, 40 NAT'L TAX J. 431, 438-442 (1987); Helen F. Ladd, *State Responses to the TRA86 Revenue Windfalls: A New Test of the Flypaper Effect*, 12 J. POL'Y ANALYSIS & MGMT. 82, 83 (1993).

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In contrast to an earlier study, the findings show a stark difference in the response of static versus dynamic conformity states. Each of the dynamic conformity states remained in tight conformity with federal law, thereby allowing federal changes to increase state taxes and change the relative distribution of state tax burdens, while each of the static conformity states made changes to their state individual income tax in order to keep state tax collections at pre-TCJA levels.¹¹ In addition, each of the static conformity states also attempted to prevent the TCJA from raising taxes for families by adding back a state tax adjustment based on family size.

Some of these findings are troubling. If state legislators would not have affirmatively voted for a bill that increased state taxes and imposed relatively higher taxes on large families, the same result should not have occurred as a result of dynamic conformity. Additionally, even in states that appeared to respond rationally to conformity by trying to preserve the status quo, they did so under significant time pressure and in many cases without robust information and analyses. While the sample presented in this article is small, it suggests that state tax conformity – or at least tight conformity that incorporates nearly all of the federal individual income tax – may work against state tax policy goals.

The article begins in Part I by providing an overview of state individual income tax, and a short summary of the existing theoretical literature on the advantages and disadvantages of conformity. Part II shifts from theory to practice, examining how states have responded to major changes in the federal individual income tax code. It first reviews the existing literature on state responses to prior federal changes before examining how those states that were in tightest conformity with federal tax law responded to the TCJA's individual income tax provisions. Part III concludes with some initial suggestions for a path forward for states that want to break free from conformity, yet achieve a simple and efficient individual income tax system that enhances taxpayers' relationship with the state.

I. STATE INDIVIDUAL INCOME TAX AND THE ADVANTAGES AND DISADVANTAGES OF STATE TAX CONFORMITY

A. The State of State Individual Income Tax

This article focuses on state individual income tax. While much more attention is given to state corporate income taxes in the existing scholarly literature, state individual income tax has a profound impact on ordinary citizens and their experience of state government, and is a much more

¹¹ My research found only a single study examining the impact of static versus dynamic conformity. That study found no statistically significant difference between these two models of conformity with respect to decisions to either conform or decouple from federal law, despite hypotheses that dynamic conformity would lead to a greater likelihood to conform to federal changes. See Michael Morrow & Robert Ricketts, *State Conformity with Federal Tax Changes*, 32 J. AM. TAX'N ASS'N 27, 29 (2010).

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significant source of state revenue than its corporate counterpart. Forty-one states and the District of Columbia currently impose a broad-based individual income tax,¹² and the revenue from individual income taxes is, on average, 37% of all tax collections and 27% of a state's total general revenue.¹³ State corporate income taxes, by contrast, account for only 5% of states' tax collections and 3.6% of states' general revenue.¹⁴ There is significant variation among the states with respect to top marginal individual income tax rates, from a high of 13.3% in California to a low of 2.9% in North Dakota.¹⁵ While most states have some type of progressive rate structure, nine states impose income tax at a flat rate.¹⁶

Nearly every state that imposes a broad-based individual income tax bases its state income tax system on the federal income tax code through a mechanism known as conformity, which incorporates federal tax law directly into state statute. There are, however, significant differences among the states in the degree to which they conform to federal tax law. At one end of the spectrum is full conformity, where a state simply imposes tax equal to a given percentage of federal income tax liability, thereby incorporating every feature of the federal system into state law other than the ultimate tax rate. The next type, which I will refer to as tight conformity, incorporates all of the basic features of the federal income tax system other than federal rates and credits. States using tight conformity begin their state income tax calculations with federal taxable income, which incorporates not only federal definitions of income, but also all federal deductions. Finally, we have what I will refer to as light conformity, which explicitly incorporates only the federal definition of gross income and a small number of favored federal deductions¹⁷ by starting state income tax calculations with a taxpayer's federal adjusted gross income.¹⁸ While these three categories can be helpful in capturing the structural differences among state income tax systems, they do not fully capture the diversity of state approaches. For example, a state that uses tight conformity may have a very long list of state-specific adjustments that result in a tax system that functions much differently than the federal system. And a state that uses light conformity might create state-specific tax provisions that closely mirror the entire federal tax structure, for example

¹² Katherine Loughead & Emma Wei, *State Individual Income Tax Rates and Brackets for 2019*, 92 ST. TAX NOTES 769, 769 (May 27, 2019).

¹³ U.S. CENSUS BUREAU, *supra* note 1 (percentages calculated by author). See also URBAN-BROOKINGS TAX POL'Y CTR., THE STATE OF STATE (AND LOCAL) TAX POLICY 9 (n.d.), https://www.taxpolicycenter.org/sites/default/files/briefing-book/the_state_of_state_and_local_taxes.pdf [perma.cc/9LF2-DE7A]

¹⁴ U.S. CENSUS BUREAU, *supra* note 1 (percentages calculated by author).

¹⁵ Loughead & Wei, *supra* note 12, at 769.

¹⁶ *Id.*

¹⁷ These deductions include, among other items, a \$250 deduction for out-of-pocket expenses for teachers, a deduction for certain contributions to individual retirement accounts, as well as a deduction for certain health savings account contributions. See I.R.C. § 62.

¹⁸ One commentator has characterized the choice between tight and light conformity as one that involves state judgment about whether they value the federal itemized deductions (in which case they might elect tight conformity), or whether their goal is to provide a broad income tax base with the lowest possible marginal rates (in which case they are more likely to elect light conformity). See Richard D. Pomp, *Restructuring a State Income Tax in Response to the Tax Reform Act of 1986*, 36 TAX NOTES 1195, 1200 (Sep. 14, 1987).

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by adding state standard and itemized deductions, as well as personal exemptions, that mirror those that exist at the federal level even if they are not incorporated by reference to federal law. For the purposes of this article, it is the extent to which federal law is directly incorporated into state law that matters most, since it is the incorporation itself that changes how state income tax law is made and updated.

There are no states that currently use full conformity, with the last three states to do so abandoning full conformity in 2001.¹⁹ At the beginning of 2018, there were six states that used tight conformity.²⁰ As discussed in more detail in Part II, that number dropped to four by 2019. Thirty-one states and the District of Columbia currently use light conformity.²¹ The remaining six states that impose a broad-based income tax do not technically conform to federal law.²²

In addition to differences in the extent of conformity, states also differ with respect to how they update their incorporation of federal law. One method is static conformity, where state statute incorporates features of the federal income tax code as of a specific date, and any future amendments to federal law do not take effect without an affirmative act of the state legislature.²³ Under the second method, dynamic conformity, state statute references the federal tax code as in effect for the relevant taxable year, and therefore any changes to relevant sections of the federal tax code automatically become part of state law, with no legislative action necessary. The states that conform to the federal individual income tax are almost evenly split when it comes to static versus dynamic conformity.²⁴

Regardless of the specific details of conformity, there are a fair number of commonalities among state individual income tax systems. Most states provide taxpayers with the choice between

¹⁹ See Walczak, *supra* note 6, at 9.

²⁰ *Id.*

²¹ *Id.*

²² Richard Auxier & Frank Sammartino, *The Tax Debate Moves to the States: The Tax Cuts and Jobs Act Creates Many Questions for States that Link to Federal Income Tax Rules*, TAX POL'Y CTR. 2 (Jan. 23, 2018) (source lists status for 2018; author modified figures to reflect 2019 changes, as well as a disagreement as to the correct classification for Idaho). While Alabama, Arkansas, Massachusetts, Mississippi, New Jersey, and Pennsylvania do not technically conform to the federal income tax code, they still incorporate aspects of the federal system as a practical matter. For example, they all use W2 wages, and many borrow amounts from a taxpayer's federal return for state income tax purposes (such as business income and loss from federal Schedule C). The difference is that these states do not specifically incorporate the federal income tax code into state statute.

²³ In some states, courts have held that static incorporation is the only permissible form of conformity, because doing otherwise is an impermissible delegation of state taxing authority. See *Wallace v. Comm'r*, 184 N.W.2d 588 (Minn. 1971). See also *Robinson v. Tax Comm'r of Indian Hill*, 61 Ohio Misc.2d 95 (Ohio Ct. Comm. Pleas 1989) (prohibiting dynamic incorporation of state tax law into municipal tax law on similar grounds).

²⁴ Auxier & Sammartino, *supra* note 22, at 3 (among states that begin with AGI, half use static conformity and half use dynamic, while among the taxable income states three are static and two are dynamic).

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itemizing their deductions or claiming a standard deduction amount.²⁵ An even more common feature is an adjustment for family size. Every state other than Pennsylvania provides some form of adjustment for family size, either in the form of personal exemptions or credits.²⁶ States differ significantly when it comes to features such as tax credits²⁷ and the treatment of capital gains and losses.²⁸ Compared to the federal income tax, state income tax systems tend to be less progressive, but they do a better job of treating taxpayers in similar circumstances equally (a concept known as “horizontal equity” in the tax literature).²⁹

B. Advantages of Conformity

States incorporate federal law into their own statutes in a variety of subject areas and for a variety of reasons.³⁰ The literature offering arguments in favor of such incorporation is well-developed, and for that reason this subpart will offer only a brief overview of the principle arguments made in favor of both state incorporation of federal law generally, as well as arguments specific to the tax context.

A frequently cited benefit of incorporation is that its use helps conserve state lawmaking resources, and is therefore more efficient than a state drafting its own statutes.³¹ Uniformity and consistency are also cited as positive benefits,³² as are lower information costs for both lawmakers and citizens.³³ And finally, the federal government’s relative expertise, particularly in highly complex scientific and technical areas, is also seen as a key rationale for incorporation.³⁴ For example, the federal government’s technical expertise and analysis may significantly outweigh a state’s capabilities, such that it makes sense for states to simply follow federal law in relevant areas

²⁵ Loughhead & Wei, *supra* note 12, at 771-78 (showing thirty-one states offered a standard deduction). *See also* WISC. LEGIS. FISCAL BUREAU, *INDIVIDUAL INCOME TAX PROVISIONS IN THE STATES* 4 (2003) (reporting that for the 2001 tax year, 33 states plus the District of Columbia provided a standard deduction).

²⁶ WISC. LEGIS. FISCAL BUREAU, *supra* note 25, at 5 (figures provided for 2001 tax year). *See also* Loughhead & Wei, *supra* note 12, at 771-78 (showing that, for 2019, thirty-five states offer some type of personal exemption deduction).

²⁷ For example, Arkansas has twenty-five state tax credits, while Connecticut has two. WISC. LEGIS. FISCAL BUREAU, *supra* note 25, at 15, 18.

²⁸ *See* Elizabeth McNichol, *State Taxes on Capital Gains*, *CTR. ON BUDGET & POL’Y PRIORITIES* 2 (Dec. 12, 2018) (finding that only nine states offer some type of state tax preference for long-term capital gains).

²⁹ Marcus C. Berliant & Robert P. Strauss, *State and Federal Tax Equity: Estimates Before and After the Tax Reform Act of 1986*, 12 *J. POL’Y ANALYSIS & MGMT.* 9, 9 (1993). The extent of progressivity, however, varies significantly by state. *Id.* at 39.

³⁰ *See generally* Scott Dodson, *The Gravitational Force of Federal Law*, 164 *U. PA. L. REV.* 703 (2016); Michael C. Dorf, *Dynamic Incorporation of Foreign Law*, 157 *U. PA. L. REV.* 103 (2008); Jim Rossi, *Dynamic Incorporation of Federal Law*, 77 *OHIO ST. L.J.* 457 (2016).

³¹ Dodson, *supra* note 30, at 731; Dorf, *supra* note 30, at 134; Rossi, *supra* note 30, at 468. *See also* Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 *J. Legal Studies* 131 (1996) (citing such rationale in the context of uniform state laws).

³² Dodson, *supra* note 30, at 736; Rossi, *supra* note 30, at 504 (noting that uniformity helps simplify an individual’s understanding of rights and obligations under the law).

³³ Ribstein & Kobayashi, *supra* note 31, at 138.

³⁴ Rossi, *supra* note 30, at 465.

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such as environmental, health, antitrust, or controlled substances regulation.³⁵ Professor Jim Rossi has also argued that state incorporation of federal law can amplify the political significance of federal law, thereby enhancing political accountability for the federal law.³⁶

The primary arguments in favor of state incorporation of federal *tax* law are administrative ease and compliance advantages.³⁷ State tax conformity is thought to ease legislative burdens, because state lawmakers can shift responsibility for a significant amount of tax legislation to the federal government. It is much simpler, after all, for a state lawmaker to simply vote in favor of adopting the existing federal tax system than to structure a state revenue system from scratch.³⁸

State tax conformity is also thought to lessen the burden on state executive and judicial branches, which can rely on both federal rulemaking and federal judicial decisions when state tax law is substantively identical to the federal code. For example, if a state conforms to the federal code's definition of a deductible business expense, then state tax agencies and state courts may rely on federal rulemaking and judicial decisions in the event of a dispute about whether a taxpayer can claim the deduction. The extensive tax guidance produced at the federal level is more than what any individual state could produce.³⁹

In addition, state tax conformity is thought to significantly simplify recordkeeping and return filing for taxpayers, as well as tax planning.⁴⁰ For example, if the state individual income tax essentially includes the same items in taxable income and allows the same deductions as the federal tax system, a taxpayer only needs to keep a single set of records and only needs to make a single decision about whether to include a specific item or deduct a specific item on both returns. Conformity may also therefore increase state tax compliance, since taxpayers only need knowledge of a single set of tax rules. For taxpayers who must file in multiple states, conformity (if adopted similarly in the relevant states) offers further simplification.⁴¹

³⁵ *Id.*

³⁶ *Id.* at 486.

³⁷ *See, e.g.,* Mason, *supra* note 4, at 1267 (claiming that these two advantages are in fact so significant that states are unlikely to ever abandon conformity). Most of the work on state tax conformity has either focused on or included state corporate tax in its analysis and, as a result, some of these arguments have much greater power in the context of sophisticated multi-state businesses than for ordinary individual taxpayers. While I am quickly summarizing the primary arguments made in favor of state conformity, Mason, *supra* note 4, comprehensively reviews both the advantages and disadvantage of conformity in detail.

³⁸ *See, e.g.,* Stark, *supra* note 4, at 423 (“The availability of the federal income tax base as a starting point in calculating state tax liability is an unqualified benefit”).

³⁹ Walczak, *supra* note 6, at 2.

⁴⁰ *See, e.g.,* LeAnn Luna & Ann Boyd Watts, *Federal Tax Legislative Changes and State Conformity*, 47 ST. TAX NOTES 619, 619 (2008).

⁴¹ Mason, *supra* note 4, at 1281-83.

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Conformity may also streamline state tax enforcement. State conformity allows states to “piggyback” on federal tax audits and participate in data exchange programs with the IRS.⁴² For example, a state that conforms to federal tax deductions may have an agreement with the IRS that requires the IRS to inform the state where a state taxpayer is found to have improperly claimed a federal tax deduction. The state thus outsources part of its tax enforcement to the federal government. It can then engage in a targeted audit or collection process involving the affected taxpayer, without having to invest the resources to identify the taxpayer. From the states’ perspective, this may decrease the cost of administration, resulting in a more efficient tax system.⁴³

C. Disadvantages of Conformity

When a state incorporates federal law by reference into its own statutes, it becomes difficult for both state lawmakers and state citizens to determine the content of the law.⁴⁴ For example, if a state passes a law incorporating federal environmental standards, lawmakers and citizens would need to then locate, read, and understand the content of that federal law in order to make an informed vote or hold legislators accountable for voting responsibly. The state lawmaking process is less transparent as result. Because of these concerns, some state constitutions explicitly prohibit such referential legislation.⁴⁵

The concerns are even greater where state law automatically incorporates any future changes to federal law. After all, under such dynamic incorporation, the federal government can have an immediate effect on state law, with no state legislative action necessary.⁴⁶ Scholars have argued, and several courts have held, that such dynamic incorporation of federal law is unconstitutional under state law, even when static incorporation is permitted.⁴⁷ Of course, even where such dynamic incorporation is legally permissible, it represents the ceding of state legislative authority to the federal government.⁴⁸

Widespread state incorporation of federal law also blunts innovation.⁴⁹ An oft-cited benefit of our federalist system of government is that states can serve as laboratories of democracy, experimenting to see which governmental interventions are most effective. When every state does the same thing, we lose that important source of experimentation and innovation.

While each of these concerns holds true in the tax context, state tax conformity comes with the unique disadvantage of exacerbating state revenue volatility.⁵⁰ Even in a perfectly designed

⁴² Luna & Watts, *supra* note 40, at 619.

⁴³ David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2595 (2005).

⁴⁴ Rossi, *supra* note 30, at 466-68. *See also* Mason, *supra* note 4, at 1301-02 (examining this issue in the tax context).

⁴⁵ Approximately twenty state constitutions limit or ban the use of referential legislation. Rossi, *supra* note 30, at 482.

⁴⁶ *Id.* at 468.

⁴⁷ For a review and critique of these constitutional arguments, *see generally* Rossi, *supra* note 30.

⁴⁸ Mason, *supra* note 4, at 1301 (describing state tax conformity as a “democratic loss for state residents”).

⁴⁹ Mason, *supra* note 4, at 1304-05.

⁵⁰ Stark, *supra* note 4, at 423-25.

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system, an income tax is always a volatile source of revenue because it can change so dramatically based on economic conditions. Indeed, this engrained volatility has led scholars to suggest that states should minimize their dependence on the income tax and embrace other, more stable forms of revenue.⁵¹ But states make this inherent income tax volatility worse by conforming their state income tax to federal law. Conformity adds a new form of revenue volatility: the volatility that results from federal tax law changes.⁵² The federal government might expand the individual income tax base, and therefore generate increased revenue for a state, but it can also narrow the tax base and thereby decrease state revenue. States, of course, are uniquely dependent on their annual revenue to provide services⁵³ and on income tax as important source of that revenue.⁵⁴ The stakes are high, and conformity makes an already imperfect system even less desirable.

II. STATE TAX CONFORMITY IN PRACTICE

While the existing literature on state tax conformity explores the theoretical aspects of conformity at great depth, this article extends that literature by examining the practical aspects of conformity. This Part begins by reviewing the process of conformity and then examines the existing empirical literature on tax conformity, before presenting the results of a study of state responses to the federal Tax Cuts and Jobs Act of 2017.

A. The Practical Dynamics of Conformity

Walking through the lifecycle of state tax conformity is helpful to understand the real-world dynamics of conformity. Conformity begins when state lawmakers make the initial decision to base the state income tax system on the federal income tax system, a decision generally motivated by a desire for simplicity for taxpayers, lawmakers, and revenue agencies. To achieve this simplicity and conform to the federal tax system, lawmakers must choose which specific line of the federal tax return is transferred to the state tax return as the starting point for state income tax calculations. The specific line chosen will determine how much federal tax policy is incorporated directly into the state tax system. A state using “total tax” on the federal return will incorporate all aspects of federal tax policy, while a state beginning with “adjusted gross income” will incorporate only federal income inclusions, exclusions, and above-the-line deductions, but avoid itemized federal deductions, the federal standard deduction, and any federal credits. While state lawmakers have limited choices here given that they must pick a starting point that exists on the federal return, the decision is not terribly problematic. Democratically accountable state

⁵¹ See, e.g., Darien Shanske, *Expanding State Fiscal Capacity, Part I: A New and Improved Consumption Tax Paired with a Tax on a Federal Windfall (the QBI Deduction)*, FLA. TAX. REV. (forthcoming).

⁵² Stark, *supra* note 4, at 423-25; Mason, *supra* note 4, at 1306-09.

⁵³ See David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CAL. L. REV. 749 (2010).

⁵⁴ URBAN-BROOKINGS TAX POL’Y CTR., *supra* note 13

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lawmakers will choose a starting point that best satisfies their preferences, even if it is within a constrained set of choices.

Once the starting point is chosen, lawmakers must decide whether and to what extent they would like to make adjustments to the starting point to achieve their desired policy result. For example, any conforming state would automatically incorporate the federal exclusion from gross income for employer-provided health insurance. If a state disagreed with the policy of allowing employed individuals to pay for such benefits with tax-free dollars, the state could enact an addition to state taxable income for such amounts. We, in fact, want state legislatures to consider these types of adjustments, because once a state has chosen to conform to federal law these adjustments are the only mechanism by which a state can maintain control of state tax policy.⁵⁵ The downside is that these desirable adjustments may undercut the simplicity rationale used to justify conformity in the first place. Starting with federal adjusted gross income and making dozens of state-specific adjustments thereto is not simpler than the state crafting its own definition of taxable income.

Of course, legislators might decide that simplicity is a higher priority than maintaining nuanced control over state tax policy and make very few, if any adjustments to the federal starting point.⁵⁶ Anecdotal evidence suggests that very few states have made that choice.⁵⁷ Even where a state tax system is initially simple, legislatures tend to add to them over time to the point that one must question whether conformity actually delivers any significant simplicity benefit to the state tax system. A quick look at state individual income tax returns will help establish this point from the taxpayer's perspective. In Arizona, it takes twenty-nine entries on the individual income tax return to get from the federal adjusted gross income starting point to state adjusted gross income.⁵⁸ In Minnesota, after filling in the starting point from the taxpayer's federal return the taxpayer must complete forty-one lines in order to arrive at Minnesota taxable income.⁵⁹ Illinois similarly has a forty-item adjustment schedule.⁶⁰ Indiana, which has an individual income tax return form that looks remarkably clean and simple, requires two separate schedules to compute Indiana add-backs (twenty-three lines) and Indiana deductions (twelve lines).⁶¹ South Carolina, which its revenue

⁵⁵ See Field, *supra* note 4, at 541 (describing conformity as ceding sovereignty).

⁵⁶ See Erin Adele Scharff, *Laboratories of Bureaucracy: Administrative Cooperation Between State and Federal Tax Authorities*, 68 TAX L. REV. 699, 712 (2015) (expressing doubt that such complete conformity would ever be likely to occur).

⁵⁷ Jane G. Gravelle & Jennifer Gravelle, *How Federal Policymakers Account for the Concerns of State and Local Governments in the Formulation of Federal Tax Policy*, 60 NAT'L TAX J. 631 (2007). See also Scharff, *supra* note 66, at 712 (expressing doubt that states would ever fully conform to the federal tax code without making state-specific adjustments).

⁵⁸ ARIZ. DEP'T REVENUE, FORM 140 (2018).

⁵⁹ MINN. DEP'T REVENUE, SCHEDULE M1M (2018).

⁶⁰ ILL. DEP'T REVENUE, SCHEDULE M (2018).

⁶¹ IND. DEPT. REVENUE, SCHEDULE 1 & SCHEDULE 2 (2018).

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department described as having “one of the simplest” individual income tax systems the country, requires twenty-three state-specific adjustments.⁶²

One factor driving increasing complexity over time is that states must respond to changes made to federal tax law after the state’s initial conformity decision. When the federal government makes changes that affect the state’s conformity point, it creates exogenous revenue and policy shocks for the state. For example, if a state elects to begin its state income tax calculations with federal taxable income and Congress adds a new federal itemized deduction, that state must consider whether it wants to conform to that change or decouple from it by adding the federal deduction back to state taxable income, a decision that will impact both state revenue and the distribution of state tax burdens.

These decisions are problematic not only because they potentially add complexity to the state tax system, but also because they take place in a context that is highly likely to distort decision-making. Once a state has decided to peg its income tax to a particular line on the federal return, any decisions to deviate from that starting point are framed accordingly. Take, for example, a state that chose to conform to federal taxable income, a starting point that incorporates all federal income inclusions and exclusions, as well as the standard and itemized deductions. If Congress passed a law doubling the standard deduction after that state’s decision to conform to federal taxable income, the state would need to decide whether to conform to that decision and double the standard deduction for state tax purposes, or whether to decouple and create a state add-back to offset the newly increased federal deduction. In a dynamic conformity state, where the federal change would automatically take effect, state legislators would be voting on a bill that could be characterized as increasing taxes because, if the state continued to conform to the federal standard deduction, state taxable income would be lower than under a system where the original standard deduction amount is retained.⁶³ In a static conformity state, the dynamics may be reversed such that updating state law to reflect current federal law could be billed as a tax decrease. The end result may be that state tax systems are shaped by distorted legislative decision-making and become complicated over time due to the need to respond to federal changes.

B. Pre-TCJA Evidence of State Responses to Changes in Federal Tax Law

The fact that state tax conformity allows changes in federal law to directly impact state revenue raises the issue of how states respond in practice to such revenue shocks. This subpart

⁶² S.C. DEP’T REVENUE, THE TAX CUTS AND JOBS ACT (TCJA): FEDERAL TAX REFORM AND THE EFFECTS ON SOUTH CAROLINA (2018), <https://www.scstatehouse.gov/CommitteeInfo/Ways&MeansIncomeTaxSubcommittee/SC%20DOR%20Tax%20Conformity%20Presentation%20to%20the%20WM%20Committee.pdf>; State of South Carolina, Department of Revenue, 2018 Individual Income Tax Return.

⁶³ See Mason, *supra* note 4, at 1327.

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reviews the existing empirical literature on this issue, which is based primarily on state reactions to the Tax Reform Act of 1986 (“TRA ‘86”), the only large-scale revision of the federal income tax code to occur between World War II and the TCJA. Described at the time as a “sweeping change,”⁶⁴ TRA ‘86 broadened the federal income tax base, lowered federal rates, and enjoyed significant bi-partisan support.⁶⁵ Similar to our current situation, at the time TRA ‘86 was passed, forty states had broad-based income taxes, thirty of which formally conformed to the federal income tax. Of the thirty states with formal conformity, they were evenly split between dynamic and static conformity.⁶⁶ Because states overwhelmingly conform only to the federal tax base, but not to its rates, states conforming to TRA ‘86 were expected to receive increased revenue as a result.⁶⁷

1. State Decisions to Conform or Decouple

In examining how conforming states respond to federal tax changes, there tend to be two distinct but related issues: whether and to what extent the state updates its statutes to reflect the current version of federal tax law and whether the state attempts to neutralize any revenue changes that might result from a decision to conform to federal changes. This section examines pre-TCJA evidence regarding the first issue.

Available evidence shows that states always update their statutes to reference the current version of the federal tax code, but they occasionally choose to decouple from specific, discrete provisions in the code. Following passage of TRA ‘86, states uniformly chose to update their state tax code to incorporate the revised version of the federal tax code, irrespective of whether they were static or dynamic conformity states. Thirty-nine of forty states were in conformity with TRA ‘86 in the first year the federal changes were effective.⁶⁸ The one outlier was merely delayed a year because of its legislative calendar.⁶⁹ Two states, Minnesota and Colorado, were prompted by TRA ‘86 to increase their state tax conformity and moved from light to tight conformity.⁷⁰

While states have always updated their cross references to the current version of the federal tax code, they often reject (or decouple from) specific provisions in the federal code. For example, the federal tax code provides favorable tax treatment to health savings accounts, but a handful of

⁶⁴ Alan J. Auerbach & Joel Slemrod, *The Economic Effects of the Tax Reform Act of 1986*, 35 J. ECON. LIT. 589, 589 (1997).

⁶⁵ *See id.* at 595. TRA ‘86 also made significant changes to the taxation of capital gains.

⁶⁶ Gold, *supra* note 10, at 431.

⁶⁷ Pomp, *supra* note 18, at 1195. Some have argued that the resulting revenue increase should not be considered a windfall because the federal government had also transferred additional responsibilities to the states. *Id.* at 1196.

⁶⁸ Auxier & Sammartino, *supra* note 22, at 4. *See also* Walczak, *supra* note 6, at 7-9 (providing an overview of states’ conformity prior to the TCJA).

⁶⁹ Auxier & Sammartino, *supra* note 22, at 4.

⁷⁰ *Id.*

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states have chosen to decouple from that treatment for state tax purposes.⁷¹ Yet we know little about what drives these state decisions to reject specific items in the federal tax code. The existing literature on legislative decision-making in this context is underdeveloped, and is limited to studies of state corporate tax provisions, not those affecting individual taxpayers.⁷² While it is perhaps understandable why studies are limited to state corporate income tax, those studies may be of limited utility in analyzing individual income tax conformity. After all, states are likely to compete for corporate taxpayers on a much different basis than they do for individual taxpayers,⁷³ who are often less mobile and much less likely to engage in a sophisticated analysis of various states' individual income tax provisions in deciding where to live.

While the state corporate tax literature may not be directly relevant, it does not give one confidence in legislative conformity decisions, suggesting instead that legislators are inconsistent in their decision-making and ignore “potentially important factors.”⁷⁴ One study found that state legislatures controlled by the same party as the federal administration that enacted a particular tax benefit are more likely to adopt that federal tax benefit at the state level, suggesting that national party affiliation may be a significant factor in determining whether a state conforms or decouples from a specific federal tax provision.⁷⁵ That correlation did not hold, however, when researchers compared a median state voter's preference compared to the political party in power at the federal level when the tax provision passed.⁷⁶ State legislators appear to follow their own party's preferences when it comes to federal tax breaks, but not those of the citizens they represent. These studies, however, were not only limited to the corporate income tax, but they also tended to involve discrete changes to the federal tax code (such as allowing bonus depreciation for some assets), rather than sweeping reform of the type enacted by TRA '86. It is therefore unclear whether its findings have much applicability in the individual income tax context.

The pre-TCJA literature therefore establishes relatively little about state decision-making around conformity. We know that no state took the seemingly untenable position of basing their individual income tax on superseded federal law, but we know little about state decisions to

⁷¹ See The HSA Report Card, State Taxation of HSAs (2018) [<https://perma.cc/7SWB-98GQ>] (describing the state tax treatment of health savings accounts, and noting that California, New Jersey, New Hampshire, and Tennessee have decoupled from federal law).

⁷² See, e.g., Luna & Watts, *supra* note 40 (examining factors influence state corporate tax conformity); Morrow & Ricketts, *supra* note 11, at 29 (examining factors that influence state corporate tax conformity and noting that researchers “have largely ignored the question of why some states choose to conform to changes in federal tax legislation while others choose not to do so”).

⁷³ See e.g., Luna & Watts, *supra* note 40, at 620 (“States are... actively competing for increasingly mobile businesses”).

⁷⁴ Morrow & Ricketts, *supra* note 11, at 33. See also Luna & Watts, *supra* note 40, at 624 (finding no statistically significant correlations among the variables studied other than a negative relationship between a state's highest marginal corporate tax rate and the decision to decouple; in other words, as the corporate tax rate rises, states will decouple from fewer federal tax provisions). Morrow & Ricketts, *supra* note 11, at 33.

⁷⁵ *Id.* at 47.

⁷⁶ *Id.*

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decouple from specific provisions in the federal tax code. One possibility is that such decisions are driven by revenue effects, a possibility explored in more detail below.

2. Do States Make Revenue-Neutral Adjustments?

One side effect of state tax conformity is that federal tax changes can directly impact and suddenly change forecasted state revenues. Theoretically, federal changes can either increase or decrease projected revenue, although each of the major federal tax reforms to date have been revenue-increasing for states. This dynamic raises the question of how states respond to such windfalls. If state governments were perfectly rational, we would expect that the state would always undo any revenue effects caused by federal tax changes.⁷⁷ After all, if state government had already determined the optimal level of taxes and spending, any external change to that mix should be reversed. Of course, from the perspective of an individual legislator, it might be perfectly rational to accept a tax increase on which he or she does not need to vote.

Setting aside tax conformity for a moment, there are many instances in which states have received an unexpected revenue windfall, or suffered an unanticipated deficit, and state legislative responses thereto have been of interest to both economists and political scientists. Windfalls have been particularly well studied because, unlike deficits, the state's decision is not forced. With a deficit, the state generally must eliminate it quickly through some combination of spending reductions and tax increases in order to comply with balanced budget requirements.⁷⁸ With a revenue windfall, lawmakers might choose to return it to taxpayers and therefore keep the size of government constant, or they might use the windfall to increase spending.

There are two types of windfalls that have been well-studied: revenue increases that result from economic growth and those that flow from intergovernmental (i.e., federal) grants. With respect to revenue increases resulting from state economic growth, evidence suggests that state governments generally reverse such increases – they make changes to the tax system, such as lowering rates, in order to keep revenue neutral.⁷⁹ In contrast, intergovernmental grants (which come from outside the state, not directly from the state's taxpayers) produce a different result. States tend to keep the revenue and increase overall spending – a phenomenon referred to as the “flypaper effect” because the external funds “stick where it hits.”⁸⁰

⁷⁷ Ladd, *supra* note 10, at 83.

⁷⁸ James M. Poterba, *State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics*, 102 J. POL. ECON. 799, 811 (1994). States with tax limitations, however, raise taxes by less in response to unanticipated deficits than do states without such limits. *Id.* at 815. States with single political party control raise taxes and cut spending by greater amounts than states where the governor is of a different political party than the legislative majority. *Id.* at 816.

⁷⁹ See, e.g., Daniel R. Feenberg & Harvey S. Rosen, *Tax Structure and Public Sector Growth*, 32 J. PUB. ECON. 185 (1987).

⁸⁰ See Ladd, *supra* note 10, at 83 (crediting Arthur Okun with the original use of the term). Given that federal grants are often made for specific purposes, with specific conditions attached, in order to get states to spend in a way they otherwise would not, the flypaper effect does not seem particularly surprising in this context.

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The dynamics of windfalls and deficits that result from state individual income tax conformity are less well studied than those in other contexts, in part because there have been relatively limited opportunities to do so. There is, however, reason to suspect that the structure of state tax conformity might lead to different decision-making than that seen in non-conformity contexts. Consider first the case of a state with dynamic conformity. If the federal government makes changes to its tax code, those changes are mirrored at the state level unless the state legislature passes a bill that changes that result. In other words, the default in the event of non-action is conformity. If the federal change has the effect of raising state taxes, state legislators in a dynamic conformity state can essentially enact a stealth tax increase: do nothing and increase revenue. At a basic level, we would expect that this dynamic might lead to higher state taxes than would be the case absent conformity. Where the federal change decreases state taxes, the opposite may be true. If legislators must pass legislation in order to keep revenue at its pre-federal change level, legislators may shy away from action – afraid to be labeled a supporter of higher taxes – and state taxes may be artificially suppressed.

The dynamics are likely different in static conformity states, since updating the cross-reference requires an affirmative legislative vote. The political pressures on that vote might be based on whether the bill can be fairly characterized as increasing or decreasing state taxes, but it may be more likely that little attention would be paid to a bill that looks like mere housekeeping rather than a change of law. Despite these reasonable hypotheses about legislative decision-making, however, the sole empirical study of the issue found no statistically significant differences between static and dynamic states with respect to decisions to either conform or decouple from federal tax law.⁸¹

Studies of TRA '86 found significant variation in how states responded to the resulting revenue windfall.⁸² Overall, economists found some evidence of the flypaper effect.⁸³ That is, state governments did not react to tax conformity windfalls by returning such amounts in full to state taxpayers but rather retained some of the revenue and increased spending. For example, one study found that states kept, on average, 40 cents of every windfall dollar resulting from TRA '86.⁸⁴ Another study estimated that states kept, on average, only 19 cents of every windfall dollar, but with significant variation among the states.⁸⁵ Among thirty-four states with windfalls, thirteen

⁸¹ Morrow & Ricketts, *supra* note 11, at 49.

⁸² Auxier & Sammartino, *supra* note 22, at 5.

⁸³ See Ladd, *supra* note 10, at 100; Gold, *supra* note 10, at 431.

⁸⁴ See Ladd, *supra* note 10, at 100. The windfall dollars were not insubstantial. As a share of income tax revenues, windfalls exceeded 10% in over half the states. *Id.* at 87.

⁸⁵ *Id.* at 90.

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returned the full amount, fifteen states returned none of the windfall, with the remaining six returning a portion of the windfall.⁸⁶

While studies of conformity found a flypaper effect following TRA '86, there is no evidence of a flypaper effect for other, smaller changes to federal tax law.⁸⁷ One explanatory hypothesis is that major federal tax changes publicize the state windfalls and, as a result, lobbyists know the state has increased fiscal capacity and therefore “[they] have something to fight about.”⁸⁸

There is much more limited evidence available about how states respond to federal tax changes that lower anticipated state revenue because such changes have been much less common.⁸⁹ Perhaps our best evidence comes from the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).⁹⁰ EGTRRA lowered federal individual income tax rates, a change that would have no impact on the vast majority of states that do not conform in any way to federal rates. However, at the time EGTRRA was passed there were three full conformity states that calculated state income taxes simply as a percentage of federal tax liability.⁹¹ With federal rates lowered, total federal tax liability was decreased, which would have resulted in decreased state revenue for those states that simply imposed a tax equal to a percentage of federal tax liability. Each of those states quickly abandoned full conformity after EGTRRA’s passage in order to preserve state revenue.⁹² While this limited evidence on federally-created state revenue decreases suggests that states do not allow conformity to artificially lower state revenue, the evidence surrounding revenue increases is less comforting. Existing studies of state responses to conformity-driven revenue increases present at least some evidence that the conformity mechanism itself results in some states increasing income taxes. The subpart below explores whether state responses to the TCJA reinforce these conclusions or offer new insights.

C. A Study of State Responses to the TCJA’s Individual Income Tax Provisions

The Tax Cuts and Jobs Act, signed into law in late December 2017, made major changes to the federal individual income tax. Because of its significant effects on the structure of the federal individual income tax, and its potential impact on states that closely conform to federal provisions, it provides an excellent opportunity to study state tax conformity in practice.

⁸⁶ *Id.* One possible benign explanation for these findings is that states were hesitant to return the full windfall amount due to uncertainty of the windfall estimates, although this does not appear to fully account for the magnitude of the windfall retention. *See id.* at 96.

⁸⁷ *Id.* at 100.

⁸⁸ *Id.* at 101.

⁸⁹ Auxier & Sammartino, *supra* note 22 at 4. *See also* Walczak, *supra* note 6, at 7 (noting that while state conformity legislation is typically a “rote action”, conforming to TCJA caused more robust debate).

⁹⁰ Pub. L. No. 107-16, 115 Stat. 100 et seq. (2001).

⁹¹ Auxier & Sammartino, *supra* note 22, at 4.

⁹² *Id.*

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To understand the impact of the TCJA on individual income taxes at both the federal and state level, it is helpful to review the basic income tax structure in place from 1987 until passage of the TCJA. The calculation to determine federal individual income tax liability begins with all of the taxpayer's income other than items specifically excluded by Congress (this starting point is referred to as "gross income").⁹³ From there, a taxpayer may deduct a small number of Congressionally-favored deductions known as "above-the-line" deductions.⁹⁴ The resulting number is known as adjusted gross income ("AGI").⁹⁵ Once AGI has been calculated, a taxpayer may deduct his or her "personal exemptions."⁹⁶ A taxpayer is entitled to a personal exemption for herself (and her spouse, if married), plus any other dependents.⁹⁷ The deduction is a flat dollar amount per personal exemption, and is intended to adjust a taxpayer's tax liability for family size. In addition, the taxpayer may deduct the larger of a standard deduction amount or his or her itemized deductions (these include many popular deductions, such as home mortgage interest, medical expenses, and charitable contributions).⁹⁸ The standard deduction is intended to simplify tax recordkeeping and filing, because taxpayers who know they will not incur itemized deductions in excess of the standard deduction amount do not need to keep track of such expenses.

After the personal exemptions and either standard or itemized deductions are taken, we arrive at taxable income, the amount to which federal tax rates are then applied.⁹⁹ Of course, there are multiple other complications such as capital gains rates, tax credits, and alternative minimum tax that may come into play, but these are not necessary to understand the basic changes made by the TCJA.

The TCJA changed the structure of the federal individual income tax by, among other things, doubling the standard deduction amount and eliminating the deduction for personal exemptions.¹⁰⁰ The TCJA also eliminated or reduced several itemized deductions, including the deductions for state and local taxes, home mortgage interest, employee business expenses, and miscellaneous itemized deductions.¹⁰¹ In order to at least partially offset the loss of personal exemptions, the child tax credit was made more generous.¹⁰² Finally, in a provision that straddles both individual and business income tax, the TCJA added section 199A to the Code, commonly

⁹³ I.R.C. §61. For example, an employer's contributions toward employee health insurance is excluded from the starting point of gross income. *Id.* §106.

⁹⁴ *Id.* §62.

⁹⁵ *Id.*

⁹⁶ *Id.* §151.

⁹⁷ *Id.* §151(b) & (c).

⁹⁸ *Id.* §63.

⁹⁹ *Id.* §§1 & 63.

¹⁰⁰ *Id.* §§63(c)(7) & 151(d)(5). *See, e.g.,* Auxier & Sammartino, *supra* note 22, at 6 (describing the changes to the standard deduction and personal exemption as "unprecedented").

¹⁰¹ *Id.* §§67(g), 163(h), & 164(b)(6).

¹⁰² *Id.* §24(h).

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referred to as the “pass-through deduction,” which allows individuals who receive business income as sole proprietors, or through certain non-corporate entities such as partnerships or LLCs, to deduct 20% of that income in arriving at their federal taxable income.¹⁰³ The TCJA also reduced most individual income tax rates, with the top rate falling from 39.5% to 37%.¹⁰⁴ Altogether, the TCJA will cause federal taxable income to increase in the aggregate, but ultimate federal tax liability will be reduced due to the rate reductions.¹⁰⁵

Nearly all of the TCJA’s changes to the individual income tax are effective only for 2018 – 2025, after which the law reverts to its pre-TCJA provisions.¹⁰⁶ While in effect, the changes to individual income tax are expected to have a profound impact on the total amount of revenue raised by the federal government, as well as on the distribution of federal tax burdens. In total, the TCJA’s individual income tax provisions, including the section 199A pass-through deduction, are expected to decrease federal revenue by \$1.1 trillion from 2018-27.¹⁰⁷ The distribution of that tax cut, however, is not uniform. In general, higher income households will receive a larger tax cut than lower income households.¹⁰⁸ The TCJA is also expected to simplify tax filing for many taxpayers by reducing the number of taxpayers who itemize their deductions from 30% of all filers to 12% post-TCJA.¹⁰⁹

The TCJA also impacts state revenue and the distribution of state tax burdens, although the nature and magnitude of these state changes varies in part based on the type of conformity a state uses.¹¹⁰ The most significant impacts will be felt by those states that begin their state tax calculations with federal taxable income (“tight conformity states”).¹¹¹ Because the TCJA

¹⁰³ *Id.* §199A.

¹⁰⁴ *Id.* §1(j). While nearly all the seven individual tax brackets were reduced, the 10% rate and the 35% rate remained unchanged. See Tax Pol’y Ctr., *How Did the Tax Cuts & Jobs Act Change Personal Taxes*, <https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-personal-taxes>.

¹⁰⁵ FRANK SAMMARTINO ET AL., THE EFFECT OF THE TCJA INDIVIDUAL INCOME TAX PROVISIONS ACROSS INCOME GROUPS AND ACROSS THE STATES 2 (2018), <https://www.taxpolicycenter.org/publications/effect-tcja-individual-income-tax-provisions-across-income-groups-and-across-states/full>. [<https://perma.cc/MFZ4-6ULY>]

¹⁰⁶ A change to the method of indexing the tax system for inflation does not sunset, however. See I.R.C. §1(f)(3).

¹⁰⁷ JOINT COMMITTEE ON TAXATION, ESTIMATED BUDGETARY EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 1, THE “TAX CUTS AND JOBS ACT” 3 (2017).

¹⁰⁸ Sammartino et al., *supra* note 95, at 4. While many taxpayers will be made better off by the doubling of the prior standard deduction, that tax cut will be more than offset in the aggregate by the loss of the personal exemption and not fully offset by the increased child tax credit. The increased standard deduction and child tax credit are expected to collectively decrease taxes by \$86.5 billion in 2018, that tax cut is more than offset by the \$93.3 billion dollar increase in taxes that will result from the loss of personal exemptions in 2018. See JCT, *supra* note 107, at 1.

¹⁰⁹ See JCT, *supra* note 107, at 1

¹¹⁰ See generally Walczak, *supra* note 6.

¹¹¹ Auxier & Sammartino, *supra* note 22, at 1. In contrast, states that lightly conform, and do not otherwise incorporate other federal tax features such as the standard deduction or personal exemption, are not expected to see significant revenue changes from TCJA conformity. Auxier & Sammartino, *supra* note 22, at 5. *But see* Walczak, *supra* note 6, at 3 (stating that “most states” were likely to see increased revenue as a result of the TCJA). One of the few changes that would impact AGI states is the elimination of the above-the-line deduction for moving expenses (for all individuals other than active duty military personnel). *Id.* at 13. While twenty-eight states use AGI as their starting point, many of those states still closely mirror the federal model of allowing the greater or a standardized or itemized

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broadened the definition of federal taxable income, states that use that amount to begin their state income tax calculations will automatically be taxing more income if they conform to the federal changes. And while rate cuts at the federal level resulted in lower overall federal income taxes, states do not conform to federal rates, with the result that conformity will simply raise state taxes in tight conformity states.

Even if a tight conformity state lowered its rates to keep revenue constant under the TCJA, the distribution of state tax burdens would change and there would be winners and losers among state taxpayers.¹¹² For example, large families may pay more in state tax post-TCJA because the loss of personal exemptions at the state level is not offset by the federal child tax credit.¹¹³ On the other hand, individual taxpayers with few itemized deductions would likely see their state taxes decreased due to the significantly increased standard deduction, as would those who receive the type of income now eligible for a section 199A deduction.

Examining the legislative responses of tight conformity states to the TCJA's significant changes should provide valuable insights on conformity's real-world dynamics. The current study therefore includes each state that was identified as using federal taxable income as the starting point for their state individual income tax calculations as of December 2017: Colorado, Idaho, Minnesota, North Dakota, South Carolina, and Vermont.¹¹⁴ While each of these states would see significant changes in state revenue and state tax distribution if it fully conformed to the TCJA, the default in the event of non-action differed depending on whether a given state used static or dynamic conformity. If a static conformity state did nothing, its taxpayers would be forced to

deduction from income, as well as deductions for personal exemption amounts. MINN. HOUSE RES., A PRESENTATION TO THE HOUSE TAXES COMMITTEE ON FEDERAL TAX CONFORMITY 6 (Jan. 22, 2019), (finding that, among the states that use AGI, eighteen have smaller standard deductions than the federal standard deduction, while nine have standard deductions equal to or greater than the federal deduction)

¹¹² Auxier & Sammartino, *supra* note 22, at 6. This would also be true of states that do not start with federal taxable income, but do incorporate the federal standard deduction and personal exemption by reference.

¹¹³ *Id.* at 11. See also Richard Auxier & Elaine Maag, *Addressing the Family-Sized Hole Federal Tax Reform Left for States*, URBAN INST. BRIEF, November 2018. At the federal level, the loss of personal exemptions is addressed by an increased federal child tax credit. But only two states, Oklahoma and New York, offer a state child tax credit that is based on the federal credit. Oklahoma's credit is equal to 5% of the federal credit, while New York's credit is equal to generally equal to 30% of the federal amount. OKLA. STAT. ANN. tit. 68, §2357; N.Y. TAX LAW §606(c-1).

¹¹⁴ Vermont was not technically a federal taxable income state when the TCJA became effective, having switched from federal taxable income to federal AGI six months prior to the TCJA's passage. See H. 516, 2017-18 Reg. Sess. (Vt. 2017). However, like Idaho, it functionally was still a taxable income state because while it began calculations with federal AGI, it then allowed federal personal exemptions and the greater of the federal standard or itemized deductions. The change was characterized as a "minor" or "administrative" change. The only functional change was that when Vermont was a taxable income state "taxpayers add back deductions they are not allowed to take [for Vermont tax purposes]" and switching to AGI meant that taxpayers would "subtract deductions and exemptions they are allowed to take [for Vermont tax purposes]." VT. LEGIS. JOINT FISCAL OFF., FISCAL NOTE, H.516 MISCELLANEOUS TAX BILL 1 (March 24, 2017). See also OFF. LEGIS. COUNCIL, SUMMARY OF ACT NO. 73 (H.516) TAXATION AND FEES 1 (noting that Vermont's individual income tax law will remain substantively unchanged, with only a difference in the mechanics of the calculation).

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compute their state taxes using outdated federal law. But if a static conformity state updated its cross-reference to current federal law and did nothing else, state taxes would rise significantly and the distribution of relative state tax burdens would be changed. For dynamic conformity states, the cross-references are updated automatically, so inaction by a state would trigger higher state taxes and changes in state tax burdens. The legislature in a dynamic conformity state would need to take positive legislative action to undue the effects of conformity. Of the six states included in the present study, four used static conformity and two used dynamic conformity.

The study first examines the baseline question of whether each of the static conformity states updated its cross-reference to the federal tax code to a date on or following the TCJA's effective date. Next, it examines whether each tight conformity state kept or returned the revenue windfall that was expected to result from the decision to conform to the TCJA. In examining the question of revenue retention, it looks at how states that chose to return revenue windfalls did so. Did states simply lower rates, or did they make state-specific adjustments to try to respond to some of the policy choices reflected in the TCJA? The study period includes any legislative sessions held in 2018 (both regular and special legislative sessions), as well as 2019 regular legislative sessions. In addition to examining enacted legislation, proposed legislation, legislative history, and media coverage of conformity in each state were also reviewed.

1. Updated Cross-References

For the four static conformity states, a foundational issue was whether they would update their reference to the federal tax code to a post-TCJA date. Unsurprisingly, each did so.¹¹⁵ After all, if a state did not update its cross references to the current version of the federal tax code, a taxpayer filing her state return in 2018 would need to calculate her federal tax liability under pre-2018 federal law because those would be the required figures for her 2018 state return. As the South Carolina Department of Revenue warned legislators, if cross references were not updated “South Carolina’s tax system will go from one of the simplest to one of the most complex in the US.”¹¹⁶ Most press reports on the issue treated this type of state statute updating as “necessary”

¹¹⁵ This finding is consistent with the corporate tax conformity literature, which found no statistically significant difference in the likelihood that a state would conform or decouple from federal corporate tax changes based on whether the state used static or dynamic conformity. Morrow & Ricketts, *supra* note 11, at 41.

¹¹⁶ S.C. DEP'T REVENUE, THE TAX CUTS AND JOBS ACT (TCJA): FEDERAL TAX REFORM AND THE EFFECTS ON SOUTH CAROLINA 9 (2018), <https://www.scstatehouse.gov/CommitteeInfo/Ways&MeansIncomeTaxSubcommittee/SC%20DOR%20Tax%20Conformity%20Presentation%20to%20the%20WM%20Committee.pdf>. Relevant to earlier discussions, this self-proclaimed simple tax system still required twenty-three state-specific additions and subtractions. See State of South Carolina, Department of Revenue, 2018 Individual Income Tax Return. [<https://perma.cc/NF63-TR7N>];

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¹¹⁷ or “automatic,”¹¹⁸ and that a failure to do so would create a “complete nightmare.”¹¹⁹ The one state that did not successfully avoid this nightmare was Minnesota, which was unable to pass conformity legislation during the 2018 legislative session.¹²⁰ It did so the following year,¹²¹ but Minnesota taxpayers did indeed have to compute their federal tax liability twice - once under current, 2018 federal law, and then again under the repealed 2016 rules that still governed Minnesota individual income tax calculations – when they completed their tax returns for 2018. The local media widely reported and highlighted the complications for taxpayers during both legislative sessions.¹²²

Given the significant negative consequences of failing to conform, it is unsurprising that every static conformity state updated their conformity date to the current version of the federal tax code. After all, the reality of forcing one’s constituents to keep track of two versions of the federal tax code would seemingly put any state legislator’s reelection prospects in question. This finding is consistent with the studies of TRA ’86 discussed earlier, which similarly found that all states quickly updated their statutes to reflect the current version of the federal tax code.¹²³

¹¹⁷ See, e.g., Jessie Van Berkel, *Dayton Offers New State Tax Plan*, STAR TRIB., Mar. 17, 2018 (stating that Minnesota “has to update its tax code because Minnesotans’ state taxes are based on their federal taxable income”); J. Patrick Coolican, *State House Passes GOP Tax Plan*, STAR TRIB., May 1, 2018 (“Every year, the Legislature *has* to bring the state tax system into alignment with federal law, an annual exercise known around the State Capitol as ‘conformity’”); Seanna Adcox, *Next Year’s Tax Filings Could be a Bigger Headache without New SC Law*, CHARLESTON POST & COURIER, Sept. 26, 2018; Seanna Adcox, *Nearly Half of SC Residents Will Pay Less on Next Year’s Tax Filings*, CHARLESTON POST & COURIER, Oct. 4, 2018 (stating that nonconformity would have been “a complete nightmare”).

¹¹⁸ See, e.g., Morgan Scarboro, *S.C. Lawmakers Must Pass ‘Tax Conformity’ Legislation*, CHARLESTON POST & COURIER, Aug. 14, 2018; Seanna Adcox, *Next Year’s Tax Filings Could be a Bigger Headache without New SC Law*, CHARLESTON POST & COURIER, Sept. 26, 2018 (“South Carolina legislators have routinely updated the state tax code to align with any new federal rules since 1985”); Sean Bennett, *Will South Carolina Take Your Federal Tax Cut?*, CHARLESTON POST & COURIER, June 4, 2018 (referring to annual conformity legislation as a “little-known, ordinarily benign routine”).

¹¹⁹ Seanna Adcox, *Nearly Half of SC Residents Will Pay Less on Next Year’s Tax Filings*, CHARLESTON POST & COURIER, Oct. 4, 2018.

¹²⁰ While both parties agreed that conformity legislation was needed, the governor vetoed the resulting legislation due to an unrelated dispute over emergency school aid. Editorial, *A Plea for Fairness in State Tax Reform*, STAR TRIB., May 10, 2018; Judy Keen, *As Promised, Dayton Vetoes Tax Bill Over Emergency School Aid Funding*, STAR TRIB., May 18, 2018.

¹²¹ H.F. 5, 91st Leg., 1st Spec. Sess. (Minn. 2019).

¹²² See, e.g., Mark Zdechlik, *Tax Preparers Expect More Extensions This Season*, MINN. PUB. RADIO, April 11, 2019 (quoting a tax preparer who reported that “This is the roughest tax season I’ve ever been through”); Jessie Van Berkel, *Dayton Offers New State Tax Plan*, STAR TRIB., Mar. 17, 2018 (stating that if Minnesota does not conform, it would create “significant confusion for tax filers and businesses”); Judy Keen, *supra* note 120 (quoting a local tax attorney describing the complexity that would result from a lack of conformity as “mind-boggling,” and another attorney predicting the consequences would be “convoluted” and “felt widely”).

¹²³ See, *infra* Part II.c.i

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2. Revenue Retention & Tax Burden Distribution

While updating a state’s cross-reference to the federal tax code appears to be more or less automatic, it is the revenue and tax policy consequences of conformity that impact state taxpayers most directly. As illustrated in Table 1 below, each tight conformity state was expected to gain increased revenue if it simply conformed to the TCJA and made no other changes to its state individual income tax system.¹²⁴

Table 1: Projected State Revenue Effects of TCJA Conformity

State	Projected Increase in State Revenue from TCJA Individual Income Tax Changes	Time Period for Estimate
Colorado	\$1.4 billion ¹²⁵	FY2017-22
Idaho	\$118.8 million ¹²⁶	2018
Minnesota	\$1.5 billion ¹²⁷	FY2018-21
North Dakota	\$15.2 million ¹²⁸	FY2017-21
South Carolina	\$169 million ¹²⁹	FY2018-19
Vermont	\$795 million ¹³⁰	Not specified

¹²⁴ Each state uses different methodology to produce such estimates. For example, states differed in whether they categorized the section 199A pass-through deduction as an individual or business tax provision.

¹²⁵ Memorandum from Colo. Legis. Council Staff to Interested Persons 3, tbl 1 (March 5, 2018) (total calculated by author using annual figures from 2017 to 2022).

¹²⁶ IDAHO STATE TAX COMMISSION, FEDERAL TAX REFORM – IDAHO IMPACT 3 (2018). When all conformity effects are taken into account (including business tax provisions), Idaho was expected to receive a net revenue increase of \$97.4 million. *Id.* at 6.

¹²⁷ MINN. DEP’T OF REVENUE, FEDERAL UPDATE: THE TAX CUTS AND JOBS ACT OF 2017 (2018), [http://www.mtc.gov/getattachment/Resources/Legislation/TCJA-\(H-R-1\)-Analysis-and-Primary-Documents/Minnesota.pdf.aspx](http://www.mtc.gov/getattachment/Resources/Legislation/TCJA-(H-R-1)-Analysis-and-Primary-Documents/Minnesota.pdf.aspx) [<https://perma.cc/98RV-P3F6>] (total calculated by author).

¹²⁸ N.D. TAX, FEDERAL TAX CUTS AND JOBS ACT (TJCA) ESTIMATED FISCAL IMPACT ON NORTH DAKOTA STATE INCOME TAXES, <https://www.nd.gov/tax/data/upfiles/media/tcja-on-nd-may-2018.pdf?20190604123625> [<https://perma.cc/DRZM-2N5F>]; (total calculated by author).

¹²⁹ S.C. REVENUE & FISCAL AFFAIRS OFF., ESTIMATED SOUTH CAROLINA IMPACT OF FEDERAL “TAX CUTS AND JOBS ACT” OF 2017 & “BIPARTISAN BUDGET ACT” OF 2018 9 (2018), [a.cc/http://rfa.sc.gov/files/Final%20Estimated%20Impact%20of%20Federal%20Tax%20Law%20Changes%20Report%205-4-2018.pdf](http://rfa.sc.gov/files/Final%20Estimated%20Impact%20of%20Federal%20Tax%20Law%20Changes%20Report%205-4-2018.pdf) [<https://perma.cc/H557-6Q82>]; (estimating that individual income to increase by \$246 million in fiscal year 2018-19, but that figure is reduced by a \$77 million tax decrease attributable solely to the section 199A pass-through deduction).

¹³⁰ Graham Campbell, Joint Fiscal Office & Peter Griffin, Office of Legislative Council, *Tax Workshop: Income Taxes and Federal Reform*, <https://ljfo.vermont.gov/assets/Subjects/Friday-Tax-Workshops-2019-Session/596453acb1/2019-Friday-Tax-Sessions-Income-Taxes-and-Federal-Reform.pdf>. [<https://perma.cc/47HS-WZKC>];

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For most states there were two separate, but related, issues. The first was whether the revenue windfall resulting from conformity would be retained, or whether the legislature would adjust the tax system to keep overall revenue at pre-TCJA levels. The second major issue for states to address was whether they wanted to adjust or attempt to offset any of the TCJA's distributional effects – a distinct tax policy issue rather than a simple revenue issue. The two issues are related, of course, because while revenue neutrality can be achieved through a simple reduction in state tax rates, revenue neutrality can also be accomplished through distributional changes. For example, adding a state personal exemption would both reduce the amount of revenue raised by the government, and also address one of the distributional changes caused by TCJA conformity. Table 2 below sets forth a summary of each state's response to these issues.

Table 2: State Responses to TCJA Conformity¹³¹

State	Political Control	Revenue Windfall Retained?	Conformity Type	Notes
Colorado	Divided in 2018 (Democratic governor and House, Republican Senate); Democratic in 2019	Yes	Dynamic	<ul style="list-style-type: none"> • Little public debate around conformity issues; • Did not decouple from any TCJA provisions
Idaho	Republican	No	Static	<ul style="list-style-type: none"> • Significant debate about loss of personal exemption; enacted state child tax credit to at least partially offset the tax increase that would otherwise affect families; • Did not decouple from §199A; • Tax rates reduced by .475% across the board
Minnesota	Divided (Democratic governor and House; Republican Senate)	No	Static	<ul style="list-style-type: none"> • Moved to light conformity (based on federal AGI) and therefore decoupled from §199A, but largely mirrored the TCJA changes with the exception of adding back a personal exemption for state tax purposes; • Second lowest tax bracket reduced by .25%

¹³¹ Underlying sources for this table can be found throughout Part II.C. in the relevant discussion of each of the states.

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North Dakota	Republican	Yes	Dynamic	<ul style="list-style-type: none"> • No real public debate or discussion of conformity; • Did not decouple from any TCJA provisions
South Carolina	Republican	No	Static	<ul style="list-style-type: none"> • Enacted two additional state child tax credits to offset distributional effects of the TCJA; • Decoupled from §199A
Vermont	Divided (Republican governor, Democratic legislature)	No	Static	<ul style="list-style-type: none"> • Moved to light conformity (based on federal AGI) and therefore decoupled from §199A, but enacted state-specific standard deduction and personal exemption that mirror federal rules pre-TCJA; • Eliminated top tax bracket and reduced remaining rates by .2%

With respect to the revenue windfall from individual income tax changes, four of the six states enacted revenue-neutral conformity legislation meaning that – on paper at least – the state kept overall tax burdens at pre-TCJA levels.¹³² For the four states that did so, this suggests that the dynamics of state tax conformity did not distort decisions about the ideal mix of state revenue and spending, and that legislators did not use conformity decisions as cover for stealth tax increases. But two states – notably the states that *automatically* incorporate federal tax changes – kept the increased revenue. Because of the potentially troubling implications of such a decision, those two states and their responses to the TCJA are explored in more detail at the end of this subpart.

While overall revenue neutrality suggests that the state did not allow federal changes to affect the desired mix of state revenue and spending, it does not tell us whether the state allowed the TCJA to alter the pre-TCJA distribution of state tax burdens, an issue that should be just as important to state lawmakers and citizens although perhaps harder to address. As a result, this study also examined the methods by which each state achieved revenue neutrality and whether, in doing so, they sought to undo some of the distributional impacts of the TCJA. It finds that every state that enacted revenue-neutral conformity made some attempt to adjust the distributional impacts caused by the TCJA.

The two most significant distributional impacts from the TCJA for state taxpayers were caused by the TCJA's elimination of the personal exemption and the new deduction under section 199A for certain types of pass-through income. Each of the four states that passed revenue-neutral conformity legislation attempted to respond to the elimination of the personal exemption by adding

¹³² VT. DEP'T TAXES, 2018 VERMONT INCOME TAX REFORM PLAN.

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some type of adjustment for family size to the state income tax,¹³³ while three of the four decoupled from the section 199A deduction.¹³⁴ Three of the four states also used modest rate cuts to help achieve revenue neutrality.¹³⁵ One state, Vermont, essentially created a state income tax system that mirrored federal law *prior* to the TCJA in order to preserve the status quo.¹³⁶

While these findings are positive, in that they suggest that state lawmakers remained actively engaged in tax policy decision-making and did not allow federal changes to dictate state results, it is worth looking at each change in more detail to better determine the effects of conformity on state legislative decision-making. One clear finding from the study is that state legislators often did not have the type of detailed information one would hope would guide tax policy decisions. Despite the clear distributional impacts of the TCJA, few states had robust estimates of those impacts in the legislative record, nor did the distributional impacts receive much media attention. In Minnesota, for example, the Department of Revenue and the House Research Department provided good overviews of the issues involved in conformity,¹³⁷ but there were no official estimates of the distributional effects of either fully conforming to the TCJA or for the ultimately passed legislation that decoupled from various provisions in the TCJA. The most significant estimate of distributional impact from an official source was a simple statement by the Minnesota Department of Revenue that “[o]ver 200,000 returns would receive tax relief in 2019” under the proposed conformity legislation.¹³⁸ The statement did not, however, specify which returns would receive such relief.¹³⁹

¹³³ H.B. 675, 64th Leg., 2d Reg. Sess. (Idaho 2018); H.F. 5, 91st Leg., 1st Spec. Sess. (Minn. 2019); H. 5341, 122nd Gen. Assemb., 2nd Reg. Sess. (S.C. 2018); H. 16, 1st Spec. Sess. (Vt. 2018).

¹³⁴ H.F. 5, 91st Leg., 1st Spec. Sess. (Minn. 2019); H. 5341, 122nd Gen. Assemb., 2nd Reg. Sess. (S.C. 2018); H. 16, 1st Spec. Sess. (Vt. 2018).

¹³⁵ H.B. 675, 64th Leg., 2d Reg. Sess. (Idaho 2018); H.F. 5, 91st Leg., 1st Spec. Sess. (Minn. 2019); H. 16, 1st Spec. Sess. (Vt. 2018).

¹³⁶ Vermont enacted a state-specific personal exemption and standard deduction in dollar amounts similar to pre-TCJA federal levels. H. 16, 1st Spec. Sess. (Vt. 2018). The bill became law without the Governor’s signature, apparently due to objections to other parts of the tax bill. *See, e.g.,* April McCollum, *VT Budget Fight Ends as Scott Allows Tax Increase to Become Law*, BURLINGTON FREE PRESS (Jun. 26, 2018), <https://www.burlingtonfreepress.com/story/news/politics/government/2018/06/26/phil-scott-allows-budget-tax-become-law-ending-vermont-budget-standoff/733879002/>.

¹³⁷ *See, e.g.,* MINN. DEP’T REVENUE, BUDGET FOR ONE MINNESOTA, MARCH 11, 2019 PRESENTATION TO HOUSE TAXES COMMITTEE 12 (March 11, 2019) (explaining that moving to AGI “Gives Minnesota the ability to determine how itemized and standard deductions meet Minnesota’s needs”); MINN. HOUSE RES., A PRESENTATION TO THE HOUSE TAXES COMMITTEE ON FEDERAL TAX CONFORMITY 18 (Jan. 22, 2019) (providing, among other things, a detailed chart of the pros and cons of retaining federal taxable income as the starting point for Minnesota income tax liability); MINN. HOUSE RES., BACKGROUND BRIEFING ON MINNESOTA TAXES 15-17 (Jan. 2019) (outlining the many choices legislators must make with respect to tax conformity).

¹³⁸ MINN. DEP’T REVENUE, *supra* note 180, at 14. *See also* MINN. DEP’T REVENUE, FEDERAL UPDATE: THE TAX CUTS AND JOBS ACT OF 2017 GENERALLY EFFECTIVE BEGINNING TAX YEAR 2019 RETROACTIVE FOR SELECT PROVISIONS (Dec. 18, 2018) (showing revenue effects of conformity, but not distribution of effects).

¹³⁹ *See id.*

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South Carolina had perhaps the most robust analysis of conformity's distributional effects. The South Carolina Revenue and Fiscal Affairs Office provided a detailed analysis of exactly how conformity would affect South Carolina taxpayers.¹⁴⁰ Overall, the Office found that conforming to the TCJA would increase South Carolina individual income taxes by \$246 million for the 2018-19 fiscal year, but that the section 199A pass-through deduction would decrease state taxes by \$77 million, for a net increase of \$169 million.¹⁴¹ The office also presented estimates of how taxpayers at varying income levels would fare.¹⁴² For example, conformity would reduce state taxes for those with more than \$1 million of income, while those with income between \$50,000 and \$125,000 would see significant state tax increases.¹⁴³ Even this best-of-the-bunch analysis did not tell the full story on distribution impact. It did not, for example, break down how families of different sizes at different income levels would be affected, nor how the benefits of the section 199A pass-through deduction would be distributed, both key impacts of TCJA conformity that would be highly relevant for state lawmakers.

In examining the specific methods by which states sought to undo the impacts of the TCJA on state taxpayers we see how the relative lack of information affected decision-making. For example, the issue of the TCJA's impact on families with three or more children received significant attention in Idaho.¹⁴⁴ The result was that the legislature passed a law providing a \$130

¹⁴⁰ S.C. REVENUE & FISCAL AFFAIRS OFF., ESTIMATED SOUTH CAROLINA IMPACT OF FEDERAL "TAX CUTS AND JOBS ACT" OF 2017 & "BIPARTISAN BUDGET ACT" OF 2018 (2018), <http://rfa.sc.gov/files/Final%20Estimated%20Impact%20of%20Federal%20Tax%20Law%20Changes%20Report%2005-4-2018.pdf>. [https://perma.cc/H557-6Q82]

¹⁴¹ *Id.* at 9.

¹⁴² *Id.* News coverage also reported on income-specific effects. See, e.g., Seanna Adcox, *Next Year's Tax Filings Could be a Bigger Headache without New SC Law*, CHARLESTON POST & COURIER, Sept. 26, 2018 ("There are still winners and losers across all income levels, depending on the household"); Seanna Adcox, *Nearly Half of SC Residents Will Pay Less on Next Year's Tax Filings*, CHARLESTON POST & COURIER, Oct. 4, 2018 (detailing that filers with over \$200,000 of income are most likely to see a state tax increase under the conformity legislation, while those earning \$30,000 or less are likely to see no change in state tax liability).

¹⁴³ S.C. REVENUE & FISCAL AFFAIRS OFF., *supra* note 183, at 19. The report also included information on the impact of the TCJA on South Carolina taxpayers' federal tax liability, so that legislators could get a sense of the overall tax burden for its citizens. *Id.* at 27 (showing an overall decrease of \$1.621 billion in federal tax liability for South Carolinians, with the largest decrease for taxpayers with income between \$100,000 and \$200,000).

¹⁴⁴ See, e.g., Kyle Pfannenstiel, *House Unanimously Passes Child-Tax Credit Bill*, COEUR D'ALENE PRESS, March 14, 2018 (quoting Representative John Gannon, D-Boise as objecting to conformity on the basis that it eliminates the personal exemption for dependent children); Cynthia Sewell, *5 Things to Watch as Idaho Lawmakers Return to Boise for 2018 Session*, IDAHO STATESMAN, Jan. 6, 2018 (noting the possibility that debates over conformity could turn the legislative session "from low-key to high-key"); Cynthia Sewell, *Gov. Otter Finds Tax Relief 'on the Backs of Families and Children,' Democrats Say*, IDAHO STATESMAN, Jan. 8, 2018 (noting Democratic opposition to conformity proposal on the basis of its impact on families and children); James Dawson, *Senate Vote Means Tax Cuts Ahead for Many Idahoans*, IDAHO STATESMAN, March 1, 2018; *Income Tax Bill Misses Final Element: Fairness for Low-Income Families*, IDAHO STATESMAN (March 4, 2018), <https://www.idahostatesman.com/opinion/editorials/article203478109.html> (noting intra-party disputes concerning the correct response to the impact on families. See, e.g., Betsy Z. Russell, *Big Tax Cut Bill Clears Senate Panel Despite Concern it Raises Taxes on Families*, IDAHO STATESMAN (Feb. 21, 2018), <https://www.idahostatesman.com/news/politics-government/state-politics/article201469704.html> (noting disagreements among Republican state senators about conformity's impact on families with children).

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nonrefundable state child tax credit.¹⁴⁵ Following the tax change, an analysis by an independent nonprofit showed that many Idahoan families would still see a significant state tax increase as a result of TCJA conformity.¹⁴⁶ The legislature then passed a second bill in the same session increasing the credit amount to \$205¹⁴⁷ – still short of the \$280 amount that was estimated to be necessary to prevent the loss of the personal exemption from increasing taxes for Idaho families. In other states, there was simply no attempt to model whether or to what extent the proposed family size adjustments would offset the TCJA’s impact on those families.¹⁴⁸

State responses to the section 199A deduction were simpler than other TCJA adjustments in that states could simply deny the deduction and fully avoid the distributional impacts it would otherwise create. It was also a potentially easier tax policy decision for the states, given that it was a highly controversial provision at the federal level,¹⁴⁹ and – unlike the purely individual tax provisions – would result in revenue loss for states if they were to adopt it.¹⁵⁰ Given each of these conditions, it seems reasonable to expect that states would decouple from section 199A.¹⁵¹ Yet only three of the six states did so.¹⁵² Idaho passed legislation specifically adopting the section 199A deduction,¹⁵³ while the two dynamic conformity states simply left the section 199A deduction in place through inaction. The rationale for Idaho’s decision is not readily ascertainable. A review of the legislative record reveals that written testimony from a nonpartisan, nonprofit tax research was received urging Idaho to decouple from the deduction on tax policy grounds.¹⁵⁴ There

¹⁴⁵ H.B. 463, 64th Leg., 2d Reg. Sess. (Idaho 2018).

¹⁴⁶ IDAHO CTR. FISCAL POL’Y, ANALYSIS OF HOUSE BILL 463, Feb. 6, 2018, <http://idahocfp.org/new/wp-content/uploads/2018/02/Analysis-of-HB463-2-6-2018.pdf>. [<https://perma.cc/RH6S-7V9A>] See also Kyle Pfannenstiel, *House Unanimously Passes Child-Tax Credit Bill*, COEUR D’ALENE PRESS (March 14, 2018), *supra* note 146.

¹⁴⁷ H.B. 675, 64th Leg., 2d Reg. Sess. (Idaho 2018).

¹⁴⁸ This statement is based on the review of publicly-available legislative materials. It is possible that such modeling was performed, but was not publicly disclosed.

¹⁴⁹ See, e.g., Daniel Shaviro, *Evaluating the New US Pass-Through Rules*, 2018 BRITISH TAX REV. 1, 49 (stating that the §199A deduction “achieved a rare and unenviable trifecta, by making the tax system less efficient, less fair, and more complicated. It lacked any coherent (or even clearly articulated) underlying principle, was shoddily executed, and ought to be promptly repealed”); David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439, 1459 (2019) (devoting an entire section of the article to “The Faulty Pass-Through Deduction”).

¹⁵⁰ The federal government estimated that it would lose \$414.5 billion in revenue over the ten years following enactment. JOINT COMMITTEE ON TAXATION, *supra* note 107, at 1. While there are no readily available estimates of the amount of revenue states would lose were they to conform, it is clear that state tax receipts would be lower if they conformed to the section 199A deduction, as it would reduce otherwise taxable income. For the status of state conformity to section 199A, see Walczak, *supra* note 6, at 19.

¹⁵¹ For a detailed discussion of why states should decouple from section 199A, see Shanske, *supra* note 51.

¹⁵² See H.F. 5, 91st Leg., 1st Spec. Sess. (Minn. 2019); H. 5341, 122nd Gen. Assemb., 2nd Reg. Sess. (S.C. 2018); H. 16, 1st Spec. Sess. (Vt. 2018).

¹⁵³ IDAHO CODE ANN. §§63-3022 & 63-3021(b)(5) (2019).

¹⁵⁴ *Idaho Should Consider Decoupling from the Pass-Through Deduction*, Hearing before the H. Comm. on Rev. & Tax’n, 64th Leg., 2nd Sess. (Idaho 2018) (written testimony of Nicole Kaeding, Director of Special Projects at the Tax Foundation)

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was also an explicit acknowledgement in the legislative record that Idaho would be the first state to conform to the section 199A deduction,¹⁵⁵ but no further information is provided. The state's decision to add the section 199A deduction was not covered by any of the news sources reviewed.¹⁵⁶

In three of the four states, the revenue windfall was not returned solely through a family size adjustment or decoupling from section 199A, but also through modest rate cuts ranging from .2 to .475%.¹⁵⁷ Rate cuts are the simplest method to arrive at a revenue target if the desire is to return any TCJA windfall to taxpayers. Rate cuts are also highly practical response when federal law makes many small adjustments that would be tedious for a state to attempt to directly offset. For example, the TCJA eliminated the ability of employers to reimburse employees for a small amount of their qualifying bicycle commuting expenses on a tax-free basis.¹⁵⁸ Such a change may well have distributional effects that a state disagrees with from a policy perspective, but the effects are so minor that it is impractical for a state to attempt to directly offset it. While blunt, state rate reductions can broadly put taxpayers at various income levels in close to the same position they would have been in absent federal changes.

Finally, one of the six states using tight conformity pre-TCJA switched to light conformity post-TCJA. By doing so, Minnesota switched from beginning state income tax calculations with federal taxable income to beginning such calculations with federal adjusted gross income, with the result that the state now directly incorporates much less of the federal income tax code.¹⁵⁹ Interestingly, while Minnesota lessened its direct incorporation of federal tax law, it still chose to largely mirror federal tax law by adopting state standard and itemized deductions that largely mirrored those adopted by the TCJA.¹⁶⁰ Presumably the switch to light conformity was an effort to limit the state's future vulnerability to federal changes, a particular concern given the TCJA's sunset.

3. Tight Conformity Outliers: Colorado and North Dakota

As noted above, only two tight conformity states allowed the changes made by the TCJA to increase state taxes. This effect is perhaps the most basic concern with conformity — that it will distort legislative decision-making on the ideal mix of taxes and spending, and allow legislators to gain revenue that they could not politically achieve if they proposed a stand-alone bill raising taxes

¹⁵⁵ Minutes, House Revenue & Taxation Committee, Idaho Legislature, Feb. 19, 2018.

¹⁵⁶ I reviewed all Idaho news sources available through Westlaw for any mention of the section 199A deduction. While some articles informed taxpayers of the availability of the deduction after it was passed, none examined the legislative decision to make it available at the state level.

¹⁵⁷ Idaho reduced each of its tax brackets by .475%. Minnesota reduced the second of its four tax brackets by .25%. Vermont eliminated its top tax bracket and reduced the remaining rates by .2% each.

¹⁵⁸ I.R.C. §132(f)(8).

¹⁵⁹ H.F. 5, 91st Leg., 1st Spec. Sess. (Minn. 2019).

¹⁶⁰ *See id.*

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(let alone a bill that effectively raised taxes on large, middle-class families). As a result, the legislative processes and related media coverage in these two states are examined in more detail.

Colorado is generally considered a “purple state.”¹⁶¹ During the first legislative session following TCJA passage, Colorado had a Democratic governor and a split legislature, with the House controlled by Democrats and the Senate controlled by Republicans.¹⁶² The election in 2018 resulted in full Democratic control of both the executive and legislative branches.¹⁶³

Colorado has a somewhat unusual state tax system given its strong “taxpayer bill of rights” (commonly referred to in Colorado by the acronym “TABOR”)¹⁶⁴ as well as a flat individual income tax rate.¹⁶⁵ Colorado’s TABOR limits the state’s year to year revenue growth based on a formula that takes into account inflation and population growth.¹⁶⁶ If the state takes in more revenue than is allowed under that formula, the excess gets refunded to taxpayers unless voters approve a spending increase.¹⁶⁷ The result is that tax increases can be particularly hard to enact in Colorado.¹⁶⁸

But Colorado is also a dynamic conformity state, meaning that federal tax changes are automatically effective unless the legislature takes affirmative action to decouple. Following the passage of the TCJA, Colorado would gain significant revenue if its legislature simply did nothing.¹⁶⁹ While it was clear that political leaders were aware of the windfall ahead of the 2018 legislative session,¹⁷⁰ a review of legislative records and news coverage shows an apparent lack of any serious effort to make the federal changes revenue neutral.¹⁷¹ Additionally, there was not much discussion in the popular press about the basic dynamics involved – that federal law changes

¹⁶¹ See, e.g., Nick Coltrain, *Colorado Democrats Seize State Trifecta: Ascendant Party Faces Electorate that Rejected Tax Increases*, FORT COLLINS COLORADAN, Nov. 6, 2018.

¹⁶² See *id.*

¹⁶³ See *id.*

¹⁶⁴ See, e.g., Anna Staver, *Colorado Taxpayers Possibly Headed for Both TABOR Refund and Tax Cut*, DENVER POST, June 19, 2019.

¹⁶⁵ COLO. REV. STAT. ANN. §39-22-104 (2018).

¹⁶⁶ COLO. CONST. art. 10, §20.

¹⁶⁷ *Id.*

¹⁶⁸ There have, however, been successful efforts to have certain amounts collected by the state by characterized as “fees” and not taxes subject to TABOR’s limits. See Kieran Nicholson, *Colorado Hospital Fees do not Violate TABOR*, *Denver District Court Rules*, DENVER POST, March 6, 2019, <https://www.denverpost.com/2019/03/06/colorado-hospital-fees-tabor-denver-district-court/> [https://perma.cc/359P-E6GS]

¹⁶⁹ Memorandum from Colorado Legislative Council Staff to Interested Persons, 71st Reg. Legis. Sess., 3, tbl. 1 (Colo. March 5, 2018) (estimating a \$1.4 billion revenue increase from 2017-22; total calculated by author).

¹⁷⁰ Auxier & Sammartino, *supra* note 22, at 10 (noting news article reporting that Colorado’s political leaders discussed keeping at least part of the TCJA windfall and spending it on infrastructure).

¹⁷¹ See, e.g., John Frank & Brian Eason, *A Look at the Top 8 Issues for the 2018 Legislative Session*, DENVER POST, Jan. 9, 2018 (discussing debates over how to spend the windfall, but not any discussion of returning the windfall).

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automatically increased state taxes.¹⁷² Democrats did propose and ultimately pass an increased child care tax credit, which presumably would help offset at least part of the tax increase on families.¹⁷³ However, the bill was not pitched or discussed as an offset to TCJA conformity. Instead, it appeared to be a stand-alone bill with an entirely separate motivation.¹⁷⁴ Senate Republicans proposed an income tax rate cut in that same legislative session, but that bill was characterized as having “no chance.”¹⁷⁵ The 2019 legislative session was similarly unresponsive to the state impact of the TCJA. While both the outgoing and incoming governors made various tax proposals that would have returned some of the windfall, no proposal made it out of legislative committee.¹⁷⁶ There were in fact no significant individual income tax bills during the 2019 session, leaving Colorado in tight conformity with federal law and with significantly increased revenue.

This result is surprising, given that the state 2018 election results seem to indicate that Colorado had significantly different policy preferences than the federal government that enacted the TCJA. There are, however, a few possible explanations. The first is an inherently practical one: Colorado’s legislature may have desired increased revenue and was happy to take advantage of

¹⁷² *But see* *GOP Tax Bill Lines Up a Potential \$300M Bump for Colorado’s Budget* (Colorado Public Radio broadcast Dec. 18, 2017); <https://www.cpr.org/2017/12/18/gop-tax-bill-lines-up-a-potential-300m-bump-for-colorados-budget/> [https://perma.cc/R999-PBMM]; Jon Caldara, *The Republican Grand Betrayal Just Keeps Getting Worse*, DENVER POST, Feb. 4, 2018, <https://www.denverpost.com/2018/02/02/the-republican-grand-betrayal-that-just-keeps-getting-worse/> [https://perma.cc/B39P-PBGB]; Nick Coltrain, *Federal Tax Reform Might Boost State Budget*, FORT COLLINS COLORADOAN, Feb. 28, 2018, <https://www.coloradoan.com/story/news/2018/02/24/federal-tax-cuts-could-boost-colorados-budget-though-who-knows-how-much/370294002/> [https://perma.cc/JPE6-CW7N]; Jon Caldara, *Colorado Stole Your Trump Tax Cut*, DENVER POST, April 14, 2019, <https://www.denverpost.com/2019/04/12/caldara-colorado-stole-your-trump-tax-cut/> [https://perma.cc/4JPC-D9BC] (each acknowledging the state tax effects of the TCJA).

¹⁷³ Brian Eason, *Expanded Child Care Tax Credit May Benefits 40,000 Families*, DENVER POST, Feb. 6, 2018, <https://www.denverpost.com/2018/02/05/proposed-colorado-tax-credit-children-40000-families-14-million/> [https://perma.cc/QPB2-SNHP]. The child tax credit was increased for families with AGI of \$60,000 or less, in an amount equal to 50% of the federal credit.

¹⁷⁴ *See, e.g. id.*; Crisanta Duran et al., *Helping Coloradans Pay for Quality Child Care*, DENVER POST, June 1, 2018, <https://www.denverpost.com/2018/06/01/helping-coloradans-pay-for-quality-child-care/> [https://perma.cc/LJ9E-2B4K] (neither of which mention the impact of the TCJA on Colorado taxes). It is likely that the increased revenue from TCJA did in fact help pay for the increased credit. *See* COLO. LEGIS. COUNCIL STAFF, FINAL FISCAL NOTE HB 18-1208, 71st Reg. Legis. Sess., at 4 (Colo. 2018) at 4 (indicating that the full cost of the credit for the first two fiscal years following enactment would be paid for out of the anticipated TABOR refund for those years).

¹⁷⁵ Brian Eason, *Dozens of Bills Offered Yearly Have No Chance*, DENVER POST, Feb. 15, 2018, <https://www.denverpost.com/2018/02/14/colorado-legislature-rejected-bills/> [https://perma.cc/LCM9-Q9G7]

¹⁷⁶ Anna Staver, *Governor Hickenlooper’s Final Colorado Budget Includes New Tax Credits for Child Care, Education*, DENVER POST, Nov. 2, 2018, <https://www.denverpost.com/2018/11/01/hickenlooper-tax-credits-final-colorado-budget/> [https://perma.cc/Z5DJ-SQJR] (describing outgoing Governor’s tax proposal); Nic Garcia, *Jared Polis Sworn in as Colorado Governor: “This is a Moment in History,”* DENVER POST, Jan. 8, 2019, <https://www.denverpost.com/2019/01/08/jared-polis-inauguration-gay-governor-colorado/> [https://perma.cc/5BZR-BK59] (describing incoming Governor’s tax proposal); Nic Garcia, *Six Things We Learned About Colorado Governor Jared Polis: His First Months in Office*, DENVER POST, May 19, 2019, <https://www.denverpost.com/2019/05/19/jared-polis-colorado-governor-first-5-months/> [https://perma.cc/6YQ9-CFJQ] (noting that incoming Governor’s proposal did not make it out of legislative committee).

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dynamic conformity to hide a tax increase.¹⁷⁷ Another possibility is that the legislature was unconcerned about the tax increase based on the belief that any significant tax increases would be undone by TABOR. While the Colorado Legislative Council's office recently predicted that TABOR refunds would be triggered in 2019 and 2020,¹⁷⁸ I could find no indication in the legislative record or media coverage that it motivated legislative inaction on TCJA conformity. It is therefore difficult to determine to what extent TABOR may explain the seeming disconnect between Colorado's political preferences and its response to the TCJA.

Even if we assume that Colorado's legislature had sound motivation for allowing the TCJA to increase state taxes, we would still expect the legislature to take into account the distributional changes caused by conformity. My research, however, found almost nothing in the legislative record or in news accounts thereof that any real consideration was given to these issues. Colorado's legislative staff did not provide estimates of relative state tax burdens post-TCJA, although they did note that families with large numbers of children "may incur a higher state tax liability" as a result of TCJA conformity.¹⁷⁹ There was no significant legislative response to that finding, nor any significant media attention paid to it.¹⁸⁰ Similarly, I did not see any indication that the legislature considered the distributional impacts or the policy choices inherent in the section 199A deduction.

As with the overall revenue increase, one might be tempted to think that the reason the Colorado legislature paid so little attention to the distributional effects of TCJA conformity is that they believed TABOR would ultimately return the tax increase, thereby solving the distributional impacts. But TABOR is not designed to reverse tax increases only for specific demographic groups. Instead, TABOR returns excess revenue through property tax relief a temporary income tax rate reduction.¹⁸¹ While such relief would reduce overall taxes owed, it would not change the fact that certain families would pay more than others. In terms of analyzing the effects of conformity on state tax systems, one must wonder if Colorado legislators would ever have voted for a tax bill that specifically increased taxes on large families while lowering taxes on certain

¹⁷⁷ There was evidence in Colorado of significant interest in raising revenue in order to better fund public education in the state. While a ballot measure proposing a tax increase specifically to fund such needs failed to pass, legislators might have been happy to have the increased TCJA revenue available for this and other spending priorities.

¹⁷⁸ COLO. LEGIS. COUNCIL STAFF, JUNE 2019 ECONOMIC & REVENUE FORECAST 15-16 (2019), <http://leg.colorado.gov/sites/default/files/images/juneforecast.pdf> (estimating that TABOR will drop the state's tax rate in 2019 and 2020 from 4.63% to 4.5%). See also Anna Staver, *Colorado's Taxpayers Possibly Headed for Both TABOR Refund & Tax Cut*, DENVER POST, June 19, 2019.

¹⁷⁹ Colo. Legis. Council Staff, *supra* note 125 at 8.

¹⁸⁰ Based on author's review of state legislative records and major state news sources.

¹⁸¹ The current TABOR mechanism provides that the first \$150 million in refunds goes to local governments to fund property tax relief. Additional refund amounts can be used to temporarily reduce the income tax rate from 4.63% to 4.5%, or to refund sales taxes based on six income-based tiers. See COLO. LEGIS. COUNCIL STAFF, MEMORANDUM TO INTERESTED PERSONS RE: HISTORY OF TABOR REFUND MECHANISMS, March 25, 2019, https://leg.colorado.gov/sites/default/files/history_of_tabor_refund_mechanisms.pdf. [<https://perma.cc/58UL-NX2R>].

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types of business income. If the answer is negative – as I suspect it is - it would be very damning evidence against at least this type of dynamic state tax conformity.¹⁸²

The second state to keep the windfall, North Dakota, is a very different state politically than Colorado. While Colorado shifted from a divided state government to a Democratically-controlled state in the November 2018 elections, North Dakota did the opposite. It went from an already heavily Republican state to one in which all state-wide offices were held by Republicans.¹⁸³ But like Colorado, North Dakota dynamically conforms to federal tax law changes. Its legislature convenes only in odd-numbered years, and so it had only a single legislative session to respond to the significant changes of the TCJA. During that session, however, there was no attempt to alter the state tax system in response to the TCJA.¹⁸⁴

The official state estimates clearly found that the TCJA would impact the distribution of income tax burdens within North Dakota, while lowering overall revenue collected.¹⁸⁵ Specifically, the TCJA would increase state individual income taxes, but that increase would be outweighed by a reduction in state business tax collections.¹⁸⁶ In the previous biennium, the legislature had to cut spending from previous levels due to decreased tax revenues, which would suggest the legislature might be interested in decoupling from those federal changes that pushed revenues even lower.¹⁸⁷ There was, however, no apparent legislative interest in decoupling from those TCJA provisions that lowered state taxes, and nearly no discussion of the change in relative

¹⁸² Of course, one might be untroubled by this result if one believes that state taxes are suboptimally low due to political pressures faced by legislators.

¹⁸³ Only a single state-wide office was held by a Democrat, Senator Heidi Heitkamp, who was defeated by a Republican challenger, Kevin Cramer, in the November 2018 elections. Jack Dura, *Republicans Reign: Cramer Claims North Dakota's second U.S. Senate Seat in Crown Jewel of Statewide Races*, BISMARCK TRIB., Nov. 7, 2018. https://bismarcktribune.com/news/election/republicans-reign-cramer-claims-north-dakota-s-second-u-s/article_d7fc4b65-d524-5010-a0ca-f9972a4a573a.html [https://perma.cc/JLU8-2HZE]

¹⁸⁴ See, e.g., *Highlights from this Legislative Session*, WILLISTON DAILY HERALD, April 29, 2019 (noting no individual income tax proposals among the major bills of the 2019 legislative session); https://www.willistonherald.com/news/state/highlights-from-this-legislative-session/article_8306330e-6aa8-11e9-ba7f-231b151700ed.html [https://perma.cc/S2UH-TN9A]; Jack Dura, 'Heavy Lifts,' *Collaboration Highlight 2019 North Dakota Legislative Session*, BISMARCK TRIBUNE, April 28, 2019 (noting same). https://bismarcktribune.com/news/local/govt-and-politics/heavy-lifts-collaboration-highlight-north-dakota-legislative-session/article_d9975fde-5450-5979-8aa9-20505d49c9c9.html [https://perma.cc/6XFR-V9BU]

¹⁸⁵ N.D. TAX, *supra* note 128.

¹⁸⁶ See *id.* (estimating \$15.2 million state tax increase for individuals and a \$42.977 million state tax decrease for businesses). See also Amy Dalrymple, *Tax Reform Projected to Decrease N.D. Revenue*, BISMARCK TRIB., Aug. 22, 2018. https://bismarcktribune.com/news/local/govt-and-politics/tax-reform-projected-to-decrease-north-dakota-revenue/article_2a07fdcd-216e-57bf-a47c-dd5c4c48ff0d.html [https://perma.cc/9BP4-MLV4]

¹⁸⁷ See, e.g., Jack Dura, *Forecasting Remains Conservative But Hopeful as New North Dakota Budget Cycle Begins*, BISMARCK TRIB., July 1, 2019 (noting use of state's rainy day fund in 2017-19 biennium to cover revenue shortfalls) https://bismarcktribune.com/news/local/govt-and-politics/forecasting-remains-conservative-but-hopeful-as-new-north-dakota-budget/article_fe76b2e0-3a6a-50c1-8b09-c894b7207b0b.html [https://perma.cc/5MKY-T8BP]; Sam Easter, *N.D. Leaders Anxiously Await Revenue Reversal*, BISMARCK TRIB., June 3, 2018 (noting tax rate decreases from 2009-16 that reduced revenue and the resulting need to cut spending). https://bismarcktribune.com/news/state-and-regional/north-dakota-leaders-anxiously-await-revenue-reversal/article_066d8583-1909-5dcb-9551-cd9ab856b337.html [https://perma.cc/X99J-GXSD]

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tax burdens.¹⁸⁸ Instead, newspapers covered the fact that nearly all North Dakotans would receive a *federal* tax cut,¹⁸⁹ and the tax commissioner and several legislators touted the fact that tax revenues would be decreased in the state – which they characterized as a tax cut without specifying that it was only a tax cut for businesses. In fact, the only significant legislative proposal during the 2019 session related to income taxes was a bill to repeal the income tax entirely.¹⁹⁰ Yet, the same legislature allowed the federal government to increase state individual income taxes.

Of course, in the state with the lowest individual income tax rates in the country, and a strong Republican majority that is likely to agree with tax policy changes enacted at the federal level, it may make sense that North Dakota continued to fully conform. But it is important to remember that the TCJA had different effects at the state level, because North Dakota does not mirror the federal child tax credits. And not even the Democratic legislators appeared to point this out or attempt to respond to it. As with Colorado, one is left to wonder whether North Dakota lawmakers would ever have voted in favor of legislation that increased taxes on large families, while simultaneously cutting taxes for businesses.

Regardless of the various factors at play in these two states, perhaps the most troubling finding of this study is that neither legislature appeared to engage in any serious debate or consideration of decoupling from any of the federal changes, nor of dropping state tax rates in order to make the change revenue neutral.¹⁹¹ And while it is understandable that states would be

¹⁸⁸ See, e.g., Jack Dura, *Governor Lays Out North Dakota Budget Proposal with Increased Spending, Raises for Public Employees*, BISMARCK TRIB., Dec. 5, 2018 (Governor’s budget proposal did not include any proposed income tax changes) https://bismarcktribune.com/news/local/govt-and-politics/governor-lays-out-north-dakota-budget-proposal-with-increased-spending/article_751aed47-4a38-58e6-9387-7779b55e5728.html [https://perma.cc/2MWP-F438]; *Legislature Facing Some Major Issues*, BISMARCK TRIB., Jan. 2, 2019 (income tax changes not listed among legislative priorities) https://bismarcktribune.com/opinion/editorial/_legislature-facing-some-major-issues/article_9b27f2b7-ca8c-5ab6-a28c-f7b9fd4c036e.html [https://perma.cc/P8CB-UEWY]; *Dem-NPL Leaders Outline Priorities*, BISMARCK TRIB., Feb. 25, 2019 (Democratic legislators criticized the lowering of corporate taxes, but did not mention or propose any response to the TCJA changes). https://bismarcktribune.com/opinion/columnists/dem-npl-leaders-outline-priorities/article_b2836dcf-ca67-55d2-a6a0-9c84847ce19a.html [https://perma.cc/PB6S-LLED]

¹⁸⁹ See, e.g., Tom Campbell, Letter to the Editor: *The Proof is in People’s Paychecks*, BISMARCK TRIB., Oct. 19, 2018 (touting federal tax cut for North Dakotans). <https://www.inforum.com/opinion/letters/4515287-letter-proof-paycheck> [https://perma.cc/5G6M-WARV]

¹⁹⁰ See John Hageman, *Chairman Eyes Income Tax Elimination*, BISMARCK TRIB., Jan. 8, 2019 (describing proposal). https://bismarcktribune.com/news/state-and-regional/chairman-of-north-dakota-tax-committee-eyes-income-tax-elimination/article_3c1a18f0-d336-5bed-b64c-5f93785a3da2.html [https://perma.cc/KZM7-2TZ3]. While the bill passed the house, the governor did not support the proposal. John Hageman, *House Approves Bill Labeled ‘Bad Policy’*, BISMARCK TRIB., Feb. 15, 2019, <https://www.inforum.com/news/government-and-politics/970279-North-Dakota-House-approves-plan-to-tap-Legacy-Fund-for-income-tax-reductions> [https://perma.cc/3NEL-AW62]. The bill failed to pass the senate. John Hageman, *Income Tax Bill Fails*, BISMARCK TRIB., Mar. 21, 2019., <https://www.prairiebusinessmagazine.com/news/government-and-politics/4587473-bill-tapping-legacy-fund-earnings-replace-income-taxes-fails> [https://perma.cc/44PQ-SRML]

¹⁹¹ Based on author’s review of bills introduced during the 2018 and 2019 legislative sessions in Colorado, and the 2019 legislative session in North Dakota.

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happy to have the increased revenue (and not have to take any political fallout from raising tax rates), these states essentially ceded their tax policy to the federal government. While it is possible this is because Colorado and North Dakota happened to have perfectly aligned preferences with the federal government, that seems unlikely. It is particularly unlikely given that the TCJA changes result in significant shifts in the distribution of tax burdens, and that the shift in burdens at the state level differs significantly from that at the federal level given that neither of these states conforms to the federal child tax credit.¹⁹²

4. Discussion

With respect to the four static conformity states, the study presents relatively good news in the sense that these states at least attempted to prevent federal changes from increasing state taxes and changing the distribution of state tax burdens. Even though these four states responded in a manner that suggests conformity did not distort state decision-making, the study illustrates three underappreciated detriments of conformity – the complexity that is added by the dynamic nature of conformity, the significant time constraints conformity imposes on state legislatures, and the fact that revenue neutrality does not mean relative state tax burdens remain unchanged.

The current study reminds us that federal tax law is dynamic, and illustrates that the exogenous revenue and policy shocks created by conformity can significantly complicate the state lawmaking process.¹⁹³ When federal tax law changes, states that disagree with either the policy choices or revenue effects thereof are forced to decouple from those changes. While this can sometimes be easily accomplished in the case of individual, discrete changes, this study shows that large, complex reforms can be difficult to respond to for tightly conforming states. With respect to the TCJA, states that conformed to federal taxable income had to interpret and respond to the combined effects of the elimination of personal exemptions, the doubling of the standard deduction, the limitation of itemized deductions, and a new deduction for specific types of business income. It would be difficult (and inaccurate) for a state to simply look at each of these items individually, rather than as a combined whole. For example, if a state disagreed with the elimination of the personal exemption, simply adding it back for state tax purposes would not necessarily be a viable solution. After all, doing so would lower state taxable income, and the

¹⁹² As the Institute on Taxation & Economic Policy noted, while automatic conformity helped raise additional revenue for state needs, “this is not an improvement in tax fairness as much of that revenue will come from middle-income families, and many of the wealthiest residents will see unnecessary state tax cuts on top of their federal tax cuts.” Dylan Grundman, *An Update on State Responses to the Federal Tax Bill*, Inst. Taxation & Econ. Pol’y, Just Taxes Blog (July 3, 2018), <https://itep.org/an-update-on-state-responses-to-the-federal-tax-bill/> [https://perma.cc/ZEY3-ZSKG].

¹⁹³ Minnesota in fact switched to tight conformity as a result of TRA ’86 and then switched to light conformity in response to TCJA. . Pat Dalton et al., *Overview of Income, Corporate Franchise, Sales and Other State Taxes: Background Information for Members of the House Committee on Taxes 17* (2019), <https://www.house.leg.state.mn.us/comm/docs/057b0e45-0cc3-4377-b7fc-b01392c18f8c.pdf>; H.F. 5, 91st Leg., 1st Spec. Sess. (Minn. 2019).

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standard deduction had just doubled, also lowering state taxable income. If a state wanted to retain the personal exemption but keep revenue neutral, it might consider reducing the standard deduction amount – but it would have to determine by how much and whether any other changes were warranted. Once a state starts adjusting multiple aspects of the TCJA, it is questionable whether tight conformity delivers much of a simplicity benefit.

Another consequence of conformity illustrated by this study is that it not only forces a state to respond to exogenous revenue and tax policy shocks caused by federal changes, but it requires them to do so under tremendous time pressure. The TCJA was signed into law in late December 2017, effective for 2018. For states, this meant they had less than one year to (1) evaluate the impact of the federal changes on their state tax system; (2) develop and pass any necessary legislative changes in response thereto, and (3) update all necessary tax forms, instructions, and software. Given that state legislatures are typically only in session for approximately the first half of the calendar year, and in some states only every-other year, it is not surprising that the study found in most states less analysis and information in the legislative record than would be considered ideal. Indeed, one would expect that this time pressure would create an incentive to simply conform to federal changes, and it is impressive that these four states resisted this easy path. In the case of the TCJA, what makes the entire conformity process even worse is that all the work states put into their response is potentially temporary given that the individual income tax provisions are scheduled to sunset in 2026.¹⁹⁴

The third key observation from this study is that examining revenue neutrality does not provide the full picture of conformity's impact on state taxes. Previous studies examining conformity's impact on states have examined the extent to which states returned any anticipated revenue windfall through rate cuts and other state tax changes. While studying the overall revenue impact of conformity is a helpful big-picture measure, it does not capture the full tax policy impact of conformity. In observing state reactions to the TCJA we can see that, while states might keep overall tax levels constant, doing so does not mean that the distribution of state tax burdens is kept constant. Instead, even revenue-neutral federal changes can result in some taxpayers shouldering a greater part of the state tax burden, while others shoulder less. The study also illustrates that it can be very difficult for states to try to undo those changes in relative tax burden, and that they often do not have the type of modeling or analyses that should be available to guide such actions.¹⁹⁵

For the dynamic conformity states in the study, the conclusions to be drawn are less favorable. These two states remained in tight conformity, and essentially ceded state individual income tax authority to the federal government, even though it (1) increased overall individual

¹⁹⁴ For a discussion of the dynamics involved in tax sunsets, see Rebecca M. Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*, 40 GA. L. REV. 335 (2006).

¹⁹⁵ See *supra* text accompanying notes 137-148.

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state taxes and (2) changed the relative distribution of state tax burdens. There are two likely explanations. The first possibility is that the revenue and policy effects of the TCJA aligned with state preferences. This rationale seems unlikely for a number of reasons. The two states had very different political preferences (suggesting that it would be odd that they would each find the TCJA's impact to be perfectly aligned with state political preferences) and the TCJA had the effect of raising state taxes on large families (an outcome it is hard to imagine any state legislator endorsing). The more likely explanation is that these states desired increased revenue, and were happy to receive it through the combination of federal legislative action and state legislative inaction. While this position is certainly understandable, it seems desirable only if one assumes that the state political process is fundamentally flawed in a manner that artificially suppresses state tax levels and that the situation is so dire *any* increased revenue, irrespective of relative tax burdens, should be embraced.

The study, while small and qualitative, is in many ways consistent with the existing empirical and theoretical literature. Every state updated its cross-references to the current version of the federal tax code, but not all states returned the resulting revenue windfall, suggesting that conformity may indeed distort state legislative decision-making. However, unlike earlier empirical studies, this study suggests that dynamic conformity may involve greater risk of state policy distortion and raises new concerns regarding conformity's impact on states. The results suggest a particular need for further empirical study of dynamic conformity and conformity's impact on the distribution of state tax burdens.

III. STATE INDIVIDUAL INCOME TAX POLICY FOR THE 21ST CENTURY

While state income tax conformity has no shortage of proponents,¹⁹⁶ this Article has illustrated some of its real world disadvantages. This Part addresses the positive implications of this evidence. If a state desires to impose an individual income tax,¹⁹⁷ how can it create an efficient, administrable system that is consistent with its values without suffering the negative consequences of conformity?

As with the rest of this Article, the focus is on the *individual* income tax system. While some individuals have highly complicated tax lives, due to pass-through entities or other complicated business or investment arrangements, my primary concern is with the average taxpayer. In general, the bulk of a state's revenue comes from these ordinary citizens, not the 1%, and my premise is that the individual income tax system should be designed with this in mind. This part attempts to provide an initial exploration of how a state could minimize the impact of

¹⁹⁶ See, e.g., Auxier & Sammartino, *supra* note 22, at 11.

¹⁹⁷ There are, certainly, arguments in favor of moving away from a state individual income tax, but I will assume for purposes of this article that the state individual income tax is sufficiently entrenched that it is unlikely to disappear entirely anytime soon.

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conformity and end up with an individual income tax system that is simple, efficient, and carefully constructed to reflect state values.

A. Carefully Weigh the Costs of Decoupling from Specific Features of the Federal Income Tax

In structuring its individual income tax system, a state should take into consideration that certain provisions in the federal income tax code are very difficult to decouple from, provisions that Professor Ruth Mason refers to as “practically nonseverable.”¹⁹⁸ These are items where the inconvenience and complexity that would result from decoupling would outweigh any potential benefits. For example, the federal tax system has rules that govern when a taxpayer realizes gain or loss for tax purposes, which generally trigger reporting such item as income or loss unless a specific nonrecognition rule applies. Similarly, the federal tax code incorporates two different methods of accounting – cash and accrual – and has significant guidance around each of these that affects the timing of when income is reported and when deductions may be claimed. Both the realization standard and accounting rules are likely practically nonseverable - a state would substantially complicate its tax administration by adopting its own, different system for determining when gain or loss and income and deductions are reported.¹⁹⁹ States would be ceding very little control of tax policy by going along with these basic standards, as their primary work is to simply put in place a set of consistent rules around timing.

Another large category I would add to Mason’s list of “practically nonseverable” provisions is the tax allocations from a business entity taxed as a partnership under federal law. As anyone familiar with partnership tax knows, the rules and regulations governing how a non-corporate entity allocates its income, gain, loss, and deduction are extraordinarily complex. Layering additional state rules on top of those rules seems untenable. This does not, of course, mean that a state must tax those allocations in the same way as the federal government. It simply means that they must accept the allocation amounts. For example, if a partner is allocated \$10,000 of income under federal partnership rules, the state can decide how to tax that \$10,000 of income, but it cannot decide that the partner should actually have been allocated \$7,000 of income.

There may, of course, be reasonable disagreements as to the precise list of items that should be considered practically nonseverable. But the importance of this concept does not depend on uniform agreement on what is or is not nonseverable. Rather, the key argument is that states should

¹⁹⁸ Mason, *supra* note 4, at 1329

¹⁹⁹ The centrality or non-negotiability of the federal realization rule has been recognized by many scholars. *See, e.g.*, Mason, *supra* note 4, at 1290; Scharff, *supra* note 66, at 703. Mason also identifies annual filing without income averaging and the exclusion of imputed income as practically nonseverable. Mason, *supra* note 4, at 1289-91.

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carefully consider the relevant costs and benefits of its decisions to conform or decouple from specific features of the federal income tax system.²⁰⁰

B. Borrow Federal Definitions, Not Federal Treatment

One frequently cited justification for conformity is that it would be impossible or impracticable for a state to develop the kind of detailed tax guidance that the federal government produces. To be clear, this is a legitimate concern, particularly for small states. It would also likely be tremendously inefficient. Do we really need fifty state governments to develop their own guidance on what qualifies as deductible home mortgage interest?

But a state can take advantage of that federal guidance without signing on to the federal tax treatment of the underlying item. For example, a state could choose to begin its individual income tax calculations from federal gross income – now referred to as “total income” on the Form 1040. One might refer this as “super light” conformity as it only includes federal income and does not incorporate *any* federal deductions. To the extent that a state decides to sign on to any of the federal deductions, it could do so by adding them to state statute using the relevant federal definition, but not incorporating the deduction wholesale from the federal code. This allows a state to benefit from federal guidance while lessening the state’s vulnerability to federal changes to the deduction itself.

Take the example of the current federal deduction for home mortgage interest. Many states conform to the federal deduction, which includes not only definitions of several terms (qualified residence, principal residence, acquisition indebtedness, home equity indebtedness), but also several quantitative limits on the deduction (the amount of principal on which interest can be deducted, how many homes can count as a qualified residence, etc.). If a state wanted to allow a deduction for home mortgage interest, it could (after careful analysis!) decide which features of the federal deduction it wanted to borrow. For example, it might make sense for a state to rely on the federal tax code definition and guidance establishing a taxpayer’s “principal residence” and “acquisition indebtedness,” but otherwise craft state-specific features. A state might decide to allow a deduction for home mortgage interest on only a single home, rather than two as the federal rules allow. Or it might adopt different quantitative limits on the principal on which mortgage interest may be deducted. The federal limit of \$750,000 of acquisition debt might be appropriate for a state with high housing prices, but it might be undesirably high for a state with modest housing prices. A state could easily make these choices, and they could be easily administered, by borrowing a few key definitions and not simply incorporating the federal deduction wholesale. While Congress might change various aspects of the deduction from time to time, it would be unlikely to change a basic definition like principal residence very often. And even if Congress

²⁰⁰ See, e.g., Shanske, *supra* note 51, (manuscript at 8-9, on file at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3324557, [perma.cc/HL99-SEQ7]) (noting that states might be better off deviating from federal depreciation rules).

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ended up repealing the home mortgage interest deduction entirely, a state could still take advantage of the existing federally-defined terms. The only impact would be a lack of future federal changes or guidance. Using this type of approach would allow a state to more finely tune its tax policy while insulating the state from future federal changes.

C. Take Advantage of Existing Data

A state tax system should generally minimize the burden of recordkeeping and return filing to the extent possible, as such costs represent deadweight losses.²⁰¹ The good news for states is that many of the items that are either included in income or would potentially be allowed as deductions are already reported by third parties. States should be cognizant of these available data sources in designing their tax systems, and take advantage of easily available data whenever possible. Doing so simplifies return preparation for taxpayers and enhances compliance and enforcement. In contrast, and related to earlier points made, the state should be careful about requiring taxpayers to keep track of information that is not otherwise available or required for federal tax filing. To the extent a state does require such information, it should clearly communicate with taxpayers on an annual basis about those state-specific items so that accurate records can be kept.²⁰² The state should also consider this additional recordkeeping burden in deciding whether the provision's benefits outweigh its costs.

In addition to third party reporting, another available data source is the IRS. The IRS and state tax authorities typically enter into data sharing agreements in order to enhance compliance and enforcement.²⁰³ For example, if the IRS determines that a taxpayer underreported his wage income, that information would typically be shared with the relevant state and therefore allow the state to take enforcement action based on the federal finding rather than an independent state audit. A common misconception is that these data sharing agreements are only available and relevant where a state conforms to the federal tax code. But, as Professor Erin Scharff documents, these data sharing agreements are in fact very flexible and do not depend in any way on state conformity.²⁰⁴ In designing its own revenue system, a state should consider this availability of federal return data and rely on it where appropriate.

²⁰¹ Amy Finkelstein, *EZ-Tax: Tax Saliency and Tax Rates*, 124 Q. J. ECON. 969, 969 (2009). Some argue that the burdens are desirable, because they increase the political saliency of taxes. *Id.* See also David Gamage & Darien Shanske, *Three Essays on Tax Saliency: Market Saliency and Political Saliency*, 65 TAX L. REV. 19, 38-40 (2011).

²⁰² For example, Minnesota allows taxpayers to deduct the cost of a child's music lessons and instrument rental, a benefit unavailable at the federal level. Under my proposal, Minnesota should annually notify taxpayers of this and any other Minnesota-specific recordkeeping in order to facilitate the return preparation process.

²⁰³ See Scharff, *supra* note 56, at 712-13.

²⁰⁴ *Id.* at 733-735.

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D. Give Up on Tax Expenditures

States desiring a simple tax system either without conformity or with minimal conformity should give serious consideration to eliminating or very substantially reducing tax expenditures,²⁰⁵ a common feature of both federal and state income tax systems. Tax expenditures, which have few fans at the federal level,²⁰⁶ are typically intended to produce some combination of behavior change or economic subsidy, but their design often seems ill-suited to these purposes and are subject to numerous critiques.²⁰⁷ The federal government, with its comparatively vast resources and tax expertise, has a hard time getting tax expenditures right, in part because it can be difficult to effectively target a tax-based subsidy so that it reaches all and only the intended recipients in the desired amount. Even where the only goal of a tax expenditure is to provide a subsidy and the expenditure is structured so that it successfully reduces the taxes of the intended recipients, its benefits can be captured by third parties through the price mechanism.²⁰⁸

For states, the situation is likely even worse. As an initial matter, a state should only mirror a federal tax expenditure if it agrees with the underlying policy rationale and believes that the expenditure is an effective method of achieving the stated goal. Even when state and federal policy preferences are perfectly aligned and the federal tax expenditure is appropriately designed, it is not

²⁰⁵ The concept of tax expenditures was pioneered by Stanley Surrey. See STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* (1973); STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985). The term “tax expenditure” is meant to capture the idea that a government forgoing revenue through a tax break is the functional equivalent of government spending and should be considered as such during the legislative process. See, e.g., Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 360-61 (1970) (providing sample analyses of tax expenditures as direct spending programs). See also Mason, *supra* note 4, at 1340-41 (discussing federal tax expenditures in the context of state tax conformity).

²⁰⁶ See, e.g., Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Credits*, 59 STAN. L. REV. 23 (2006); Hickman, *supra* note 2; Jason S. Oh, *The Social Cost of Tax Expenditure Reform*, 66 TAX L. REV. 63 (2012); Edward D. Kleinbard, *The Congress within the Congress: How Tax Expenditures Distort Our Budget and Political Process*, 36 OHIO N.U. L. REV. 1 (2010); David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275 (2015); Phyllis C. Smith, *The Elusive Cap and Gown: The Impact of Tax Policy on Access to Higher Education*, 10 BERKELEY J. AFR.-AM. L. & POL’Y 181 (2008); David A. Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823 (2006).

²⁰⁷ See, e.g., Gregory S. Burge, *Do Tenants Capture the Benefits from the Low-Income Housing Tax Credit Program?*, 39 REAL ESTATE ECON. 71 (2011); Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses*, in *COLLEGE CHOICES: THE ECONOMICS OF WHERE TO GO, WHEN TO GO, AND HOW TO PAY FOR IT* (Caroline Hoxby, ed., 2004). But see Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L. J. 1165 (1993).

²⁰⁸ For example, when the federal government offered widely available tax credits of \$1,500 to offset the cost of the first two years of post-secondary education, evidence suggests that community colleges raised their prices, thereby capturing the credit for themselves. Long, *supra* note 262, at 155-58. Similarly, there is evidence that the economic benefit of the home mortgage interest deduction has been captured by home sellers through increased prices rather than improving affordability for buyers. See, e.g. Steven C. Bourassa & Ming Yin, *Tax Deductions, Tax Credits and the Home Ownership Rate of Young Urban Adults in the U.S.*, 45 URBAN STUDIES 1141 (2008). See also WILL FISCHER & CHYE-CHING HUANG, *MORTGAGE INTEREST DEDUCTION IS RIPE FOR REFORM*, CTR. BUDGET & POL’Y PRIORITIES, June 2013, <https://www.cbpp.org/sites/default/files/atoms/files/4-4-13hous.pdf> (noting that the deduction primarily benefits high-income, not middle- or low-income taxpayers, and that three major bipartisan tax reform panels have recommended it be substantially changed or eliminated).

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obvious that mirroring the expenditure at the state level would deliver the same results. If the goal is behavior change, state tax expenditures have less power than their federal counterparts due to comparatively lower tax rates. And if the goal is to provide a subsidy to certain activity, the state would have to decide that a state subsidy on top of the federal subsidy provides the correct level of support for the given transaction.

A state could avoid these interaction effects by designing its own state tax expenditures that reflect state policy priorities, but doing so requires the more limited resources of a state government to produce sophisticated economic modeling and legislative analysis to get it right. It seems unlikely that many state-created tax expenditures would be worth the costs involved both in terms of expenditure design and added complexity to the tax system. Given both the criticisms and complications of tax expenditures, states should strongly consider erring on the side of simplicity²⁰⁹ and either eliminate or severely limit their use of tax expenditures within their individual income tax system.

E. Design Around the Taxpayer Experience

A key feature of state individual income tax systems is the ability of a tax system to profoundly shape the relationship between citizens and the state. Taxes play a significant role in forming civic identity.²¹⁰ They determine, in some measure, both what an individual owes society and the reach of a state's power.²¹¹ Individual income tax policy therefore gives states a unique ability not only to raise the appropriate amount of revenue for their state, but to shape how citizens perceive the state and its services, and to distribute burdens in a manner that reflects state values. Taxation "establishes one of the most widely and persistently experienced relationships that individuals have with their government."²¹² Given the importance of the individual income tax to a state's relationship with its citizens, its design is worthy of careful consideration, not a simple duplication of a federal system few are happy with.

A final piece of the individual income tax design puzzle is therefore to give careful consideration to the taxpayer experience. States should consider fundamental issues such as what filing returns should look like, or whether returns should be required at all, and if so, for which

²⁰⁹ As Richard Pomp has observed, it is generally easier, at the state level, to "strike the balance on the side of simplicity." Pomp, *supra* note 18, at 1199.

²¹⁰ Isaac William Martin, Ajay K. Mehrotra, & Monica Prasad, *The Thunder of History: The Origins and Development of the New Fiscal Sociology* 1, in *THE NEW FISCAL SOCIOLOGY: TAXATION IN COMPARATIVE AND HISTORICAL PERSPECTIVE* (Isaac William Martin, Ajay K. Mehrotra & Monica Prasad, eds. 2009). For discussions of the role of tax in civic identity and political and social community, see LAWRENCE ZELENAK, *LEARNING TO LOVE FORM 1040: TWO CHEERS FOR THE RETURN-BASED MASS INCOME TAX* (2013); Ajay K. Mehrotra, *Reviving Fiscal Citizenship*, 113 MICH. L. REV. 943 (2015)(reviewing Zelenak's *Learning to Love Form 1040*); MORTON KELLER, *REGULATING A NEW ECONOMY: PUBLIC POLICY AND ECONOMIC CHANGE IN AMERICA, 1900-1933* 209 (1996).

²¹¹ Martin et al., *supra* note 210, at 1.

²¹² *Id.* at 3.

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taxpayers.²¹³ A state might decide to make return filing broadly required, but as simple as possible through mechanisms such as pre-filled returns²¹⁴ or even a mobile application that allows taxpayers to file their return on their phone simply by agreeing to the accuracy of third-party reported data.²¹⁵ States could eliminate tax returns altogether,²¹⁶ or go in the opposite direction and make everyone fill out their tax returns using paper and pen. States could eliminate withholding so that a single (highly salient) payment must be made at tax filing, so that citizens feel their taxes “good and hard.”²¹⁷ States can make similar decisions about optimal enforcement of whatever tax system they adopt.²¹⁸ Indeed, one could argue that state government has an obligation to consider these weighty issues, and to come to independent conclusions on them.²¹⁹

There is no one prescription that will be perfect for each state, but it is critical that each state thoughtfully consider their citizens’ taxpaying experience. To the extent that states are able to develop systems that simplify tax administration, they could help their residents save some of the extraordinary sums that are currently spent on tax preparation costs.²²⁰ And to the extent they thoughtfully design the return process to be consistent with state values, they will be able to harness the tax return’s civic potential.²²¹

F. Protect the System Through Institutional Safeguards

One might have read the above suggestions with a bit of skepticism. After all, even if lawmakers initially construct a simple, efficient income tax system, political economy would suggest that those same lawmakers may be highly tempted to use that tax system in future years to curry political favor, such that the end result is a system that is just as complicated as the one that existed under conformity. To quote one commentator, over time, state income tax systems

²¹³ For example, Professor Michael Graetz has proposed limiting return filing to a wealthy minority of taxpayers. MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2008).

²¹⁴ See Joseph Bankman et al., *Using the “Smart Return” to Reduce Evasion and Simplify Tax Filing*, 69 *Tax L. Rev.* 459 (2016).

²¹⁵ The Netherlands has such a mobile app and, in Sweden, taxes can be completed for some taxpayers by responding “yes” to a text message. Derek Thompson, *The 10-Second Tax Return*, *THE ATLANTIC*, March 20, 2016.

²¹⁶ William G. Gale & Janet Holtzblatt, *On the Possibility of a No-return Tax System*, 50 *NAT’L TAX J.* 475 (1997).

²¹⁷ Chris Edwards, *Options for Tax Reform*, 106 *TAX NOTES* 1529, 1538 (2005).

²¹⁸ For a discussion of tax enforcement and optimal deterrence, see Joel Slemrod, *Tax Compliance and Enforcement: New Research and its Policy Implications*, University of Michigan Ross School of Business Working Paper No. 1302 (Jan. 2016).

²¹⁹ See Mehrotra, *supra* note 210, at 968-69 (discussing that citizens not only have a responsibility to pay their taxes, but that “governmental officials have a reciprocal social obligation and democratic duty to their citizens” when it comes to raising revenue and distributing the burden thereof). Of course, it may not always be clear to policymakers which approach is most desirable. For a discussion of some of the difficulties in tax system design, see Gamage & Shanske, *supra* note 201.

²²⁰ While there is no readily available public data on the specific costs of *state* return preparation, the total figure for return preparation costs in the United States are estimated at around \$15 billion per year. ZELENAK, *supra* note 210, at 2.

²²¹ *Id.* at 5.

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“degenerate and deteriorate into a state of disorder, chaos, and inconsistency,” like “a garbage pail that is never emptied.”²²²

To combat such tendencies, states should consider enacting institutional safeguards to make it more difficult to complicate the state tax code. One can imagine many different mechanisms that might be used. For example, state statute might require a super majority to pass any tax expenditure legislation. If there is concern that such a requirement might be too big a hurdle (and therefore might needlessly paralyze tax policy decision-making), softer restraints might be put in place, such as requiring specific, detailed modeling and analysis of any tax code amendments before they can be considered by the legislature. Similarly, any tax bill affecting individual taxpayers might require an analysis of the bookkeeping requirements and recordkeeping burden prior to bill consideration. A slightly tougher approach might be to not only require such analysis before initial bill consideration, but also require a follow-up study after a specific number of years in order to ensure that the change is having its desired effect. Restrictions could also be based on the return itself. A state could cap the number of lines of information on a tax return, such that the legislature would have to remove one adjustment if it wanted to add a new one.

Another approach is to require all tax laws to automatically sunset after a certain number of years, requiring a future legislature to authorize the continuation of the provision in an attempt to encourage continuing attention to how the particular provision is working.²²³ Other innovative design features should be considered as well, such as dynamic legislation that might automatically repeal tax provisions if certain targets are not met, or outcomes not achieved.²²⁴ The possibilities are limitless, and state lawmakers would serve their citizens well by considering simplicity-preserving protections.

CONCLUSION

While conforming to the federal income tax code is the norm for states that impose a broad-based income tax and is a practice that enjoys relatively widespread support in the literature, theorists have expressed concern that doing so comes at a price. They explain that while conformity might be supported on the basis that it simplifies state tax systems, it also increases revenue volatility and may distort state legislative decision-making. Prior empirical studies, however, have failed to reach strong conclusions about what guides state behavior where federal tax changes create revenue and policy shocks for conforming states.

²²² Pomp, *supra* note 18, at 1196.

²²³ Of course, it can be hard as a political matter to take away a perceived tax benefit, even if temporarily enacted. See Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. REV. 656 (2007) (noting that, “[e]ven if a tax cut is intended to be in effect for only a short period of time, it is politically challenging to allow the cut to expire”).

²²⁴ Rebecca M. Kysar, *Dynamic Legislation*, 167 U. PA. L. REV. 809 (2018).

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This article has presented the findings of a study of state responses to recently enacted federal individual income tax changes in an attempt to illustrate some of the real-world dynamics of conformity. In the six states that tightly conformed to federal tax law, the TCJA was expected to significantly increase state individual income taxes, and also change the relative tax burdens among state taxpayers. In four of those states, lawmakers took action to prevent the federal changes from increasing state taxes and attempted to counteract the change in relative tax burdens by using state-specific adjustments. The remaining two states fully accepted the federal changes, despite the resulting increase in state taxes. In neither case were the outcomes ideal. States either allowed the federal government to increase taxes and change state tax burdens, or they struggled under significant time pressures to attempt to undo federal policy based on imperfect data and analyses.

The good news is that it is possible for states to regain control of their individual income tax policy, and do so in a way that embraces simplicity and efficiency. While states will never be able to wholly free themselves from the impact of federal tax policy,²²⁵ they can and should minimize the impact federal tax changes have on the state tax system and embrace their power and responsibility to structure a state tax system that is responsive to their citizens.

²²⁵ For example, the federal deductibility of state and local taxes will create various pressures and incentives at the state level even if a state tax system is completely decoupled from federal tax. *See, e.g.*, Paul N. Courant & Daniel L. Rubinfeld, *Tax Reform: Implications for the State-Local Public Sector*, 1 *ECON. PERSP.* 87, 88 (1987) (discussing how the Tax Reform Act of 1986's elimination of the deduction for state sales taxes would probably result in states shifting away from sales taxes in favor of still-deductible income taxes and noting the federal tax code's impact on state revenue-raising through the taxation of state and local bonds); Gilbert E. Metcalf, *Tax Exporting, Federal Deductibility, and State Tax Structure* 12 *J. POL'Y ANALYSIS & MGMT.* 109 (1993) (examining the effect of the Tax Reform Act of 1986's impact on state tax structure).