

## HJR 61 Review of State Conformity with Federal Income Tax Laws

This outline reviews some issues raised at the Revenue and Transportation Committee's December 7, 2007, meeting by Harley Duncan, Federation of Tax Administrators, of state tax conformity with federal income tax law and contains a review of a bill in California that would conform to a specific provision of federal income tax law.

Forty-one states and D.C. impose broad-based individual income tax and 46 states impose corporation tax that uses net income as part of the base

State tax bases generally follow the federal base--definitions of income, deductions allowed, and tax treatment of various transactions

- taxpayer convenience and compliance
- rely on federal definitions
- ease of administration and share information

Individual income taxes starting point

- 28 states begin with federal adjusted gross income
- 9 states begin with federal taxable income
- state modifications
  - Montana add interest on state, county, or municipal bonds
  - Montana subtract interest on federal obligations, unemployment compensation and workers' compensation, certain tips and gratuities
- state personal exemptions
- standard deductions or itemized deductions (based on federal deductions)--33 states allow itemized deductions, but may vary--e.g., Montana allows health insurance and long-term care insurance deduction without regard to 7.5% floor
- state taxable income

Corporations

Substantial conformity

Type of conformity: adopted by statutory reference or specify federal taxable income as the starting point; state modifications

federal tax form 1120

line 28: taxable income before net operating loss deduction (most states start here)

line 30: taxable income after net operating loss deduction

Types of conformity--see attached table

- Rolling conformity--automatically conforms to federal law
  - individual income tax--18 states (Montana) and D.C.
  - "rolling" changes question from "shall we conform?" to "shall we nonconform" (if the question comes up at all)
  - delegation of legislative authority
- Fixed date conformity--tied to federal law as of specific date--legislative action to change
  - Individual income tax--18 states

- Five states do not conform to federal base

Federal tax law changes have led to some states to not adopt or decouple from certain provisions:

Bonus depreciation (Job Creation and Worker Assistance Act, 2002, and Jobs and Growth Tax Relief Act, 2003)--13 conform, 25 nonconformed, 9 hybrid  
 Section 179 small business expensing--18 nonconformed  
 Section 199 deduction for qualified production activity income--19 nonconformed  
 Estate tax--18 states retain estate tax by establishing a conforming year

Federal changes to stimulate economic growth and investment but states constrained by revenue and balanced budgets particularly during economic recession--regardless of type of conformity, federal policy affects state policy

Consequences of nonconformity

- Increases complexity for taxpayer
- If nonconformity involves a known amount then complexity not a problem
- Nonconforming to depreciation--2 sets of books, different basis, recognize different amounts on disposition--more complex for multistate taxpayers
- Complexity may compel conformity, e.g. determining basis of IRAs

Regardless of committee's recommendation regarding the HJR 61 study, it may want to include in its work plan a routine review of federal income tax law and potential effects on Montana.

Example of fixed date conformity and conforming legislation:

California conforms with the Internal Revenue Code as it read on January 1, 2005. The previous conforming date was January 1, 2001. By changing the conforming date, California generally conformed with federal law enacted after January 1, 2001. The state had previously conformed with the Military Family Tax Relief Act of 2003 and the Service Members Civil Relief Act of 2003, and a few other pieces of federal legislation. Despite the new conforming date, California specifically excludes some federal provisions, including but not limited to:

- the additional first year bonus depreciation;
- the deduction of income attributable to domestic production activities;
- the election to currently expense the cost of qualified film and television production costs;
- the tax deferral allowed for gains on electric transmission assets;
- the above-the-line deduction for qualified tuition and related expenses;
- the above the line deduction for qualified expenses incurred by elementary and secondary teachers;
- health savings account, provisions, including the exclusion of employer contributions to an employees health care savings account.

Legislation was introduced late last year to allow a deduction on California individual income tax returns for contributions to a health savings account as is allowed on the federal return.<sup>1</sup> It would also allow amended returns to be filed for tax year 2006 to claim the deduction and refund penalties assessed on amounts rolled over from an Archer medical savings account from that tax year. When California revised its conformity date, it specifically did not conform to the HSA provisions.

Under federal law, individuals with a high deductible health plan (HDHP), and no other health plan other than a plan that provides certain permitted coverage, may establish a health savings account (HSA). In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses.

Contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual in determining adjusted gross income (i.e. "above-the-line"). Contributions to an HSA may be excluded from income and employment taxes if made by the employer. Earnings on and qualified distributions from an HSAs are not taxable.

The bill as introduced did not conform to changes made to HSAs by the Tax Relief and Health Care Act of 2006 that apply to 2007 and later years. The analysis of the bill pointed out that the HSA rules for 2007 and later years would be different for California taxpayers and suggested that California rules for 2007 and later years be the same as those contained in the TRHCA. In addition, the analysis suggested that the legislation provide a basis recovery adjustment for amounts in the account before the legislation becomes effective.

The fiscal impact of the bill ranged from -\$5 million in fiscal year 2007 to -\$28 million in fiscal year 2010.

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<sup>1</sup>Discussion based on "Analysis of Original Bill", SBX1 10, Health Savings Account (HSA) Deduction Conformity, California Franchise Board, November 27, 2007.

# STATE PERSONAL INCOME TAXES: FEDERAL STARTING POINTS

(as of January 1, 2007)

<b>STATE</b>	<b>Relation to Internal Revenue Code</b>	<b>Tax Base</b>
ALABAMA	---	---
ALASKA	no state income tax	
ARIZONA	1/1/06	federal adjusted gross income
ARKANSAS	---	---
CALIFORNIA	1/1/05	federal adjusted gross income
COLORADO	Current	federal taxable income
CONNECTICUT	Current	federal adjusted gross income
DELAWARE	Current	federal adjusted gross income
FLORIDA	no state income tax	
GEORGIA	1/1/06	federal adjusted gross income
HAWAII	12/31/05	federal adjusted gross income
IDAHO	1/1/06	federal taxable income
ILLINOIS	Current	federal adjusted gross income
INDIANA	1/1/06	federal adjusted gross income
IOWA	1/1/06	federal adjusted gross income
KANSAS	Current	federal adjusted gross income
KENTUCKY	12/31/04	federal adjusted gross income
LOUISIANA	Current	federal adjusted gross income
MAINE	12/31/05	federal adjusted gross income
MARYLAND	Current	federal adjusted gross income
MASSACHUSETTS	Current	federal adjusted gross income
MICHIGAN	Current (a)	federal adjusted gross income
MINNESOTA	5/18/06	federal taxable income
MISSISSIPPI	---	---
MISSOURI	Current	federal adjusted gross income
MONTANA	Current	federal adjusted gross income
NEBRASKA	2/14/07	federal adjusted gross income
NEVADA	no state income tax	
NEW HAMPSHIRE	on interest & dividends only	

NEW JERSEY	---	---
NEW MEXICO	Current	federal adjusted gross income
NEW YORK	Current	federal adjusted gross income
NORTH CAROLINA	1/1/06	federal taxable income
NORTH DAKOTA	Current	federal taxable income
OHIO	Current	federal adjusted gross income
OKLAHOMA	Current	federal adjusted gross income
OREGON	Current	federal taxable income
PENNSYLVANIA	---	---
RHODE ISLAND	6/3/01	federal adjusted gross income
SOUTH CAROLINA	12/31/05	federal taxable income
SOUTH DAKOTA	no state income tax	
TENNESSEE	on interest & dividends only	
TEXAS	no state income tax	
UTAH	Current	federal taxable income
VERMONT	1/1/05	federal taxable income
VIRGINIA	12/31/05	federal adjusted gross income
WASHINGTON	no state income tax	
WEST VIRGINIA	1/1/06	federal adjusted gross income
WISCONSIN	12/31/04	federal adjusted gross income
WYOMING	no state income tax	
DIST. OF COLUMBIA	Current	federal adjusted gross income

Source: Compiled by the Federation of Tax Administrators from various sources.

--- state does not employ a federal starting point. Current indicates state has adopted IRC as currently in effect. Dates indicate state has adopted IRC as amended to that date. (a) or 1/1/99, taxpayer's option.