



Additional Analysis: Impacts of House Bill 463 Including the Pass-Through Deduction (199A) Provision February 20, 2018

Note: The Idaho Center for Fiscal Policy previously released analysis of House Bill 463. As explained in that brief, the analysis did not include the impacts of business tax provisions. The Center can now provide an analysis of the proposal that accounts for the impact of the pass-through deduction specifically. Other business provisions remain outside of the scope of this analysis. The impact of a proposed reduction in the state corporate rate is excluded from this analysis. That impact would primarily flow to the top earners. The Center has also simplified this analysis by providing all charts with the same income ranges across different family sizes.

House Bill 463 would make substantial changes to Idaho's tax code, in part as a response to recent federal tax cuts. The legislation would also cut Idaho's state income tax rates for households and corporations, changing significantly the way the income tax load is carried by residents. The proposal also includes a nonrefundable state child tax credit, although this does not offset the tax increases for some Idaho families from full conformity.

One motivation for reducing taxes this year is to offset the increase in revenue that full conformity – aligning our state tax code with recent federal changes – could bring. If Idaho chooses to fully conform, the state may collect additional revenue in the range of \$7 million to \$97.4 million.¹ While elimination of the personal and dependent exemptions will increase state revenue, a new deduction for pass-through income in this legislation could cost up to \$74 million, reducing most of that gain.²

Some Idahoans – particularly those with multiple children - will nonetheless pay more in state taxes from full conformity. Idaho legislators have expressed a desire to reform state taxes so that dollars flow back to the households that experience a higher tax bill due to conformity.³ Analysis of this proposal shows that its tax cuts do not target these impacted households as much as they do high-earning households. The combined effect of full conformity and tax changes in House Bill 463 on all households would be a \$69 tax cut, on average, for the middle 20 percent of Idaho households and a tax cut exceeding \$8,700 for the top 1 percent. Households with several children are generally worse off and would see their taxes go up under this proposal (see chart on page 2).

Idaho's relatively strong economic growth in the past few years has produced revenue that has, for the most part, been invested in policy priorities that were cut deeply during the recession, and are strongly linked with long-term economic growth, such as schools and health services for children. Notably, this proposal would reduce revenue more than other recent state tax proposals. The fiscal impact of this tax proposal would be far deeper than offsetting the revenue gained by conformity.

¹ The low estimate was modeled by the Institute on Taxation and Economic Policy (ITEP). ITEP estimates do not model every conformity-related business provision that could affect revenue, in part due to the uncertainty in establishing assumptions about such provisions. This analysis includes an estimate of the impact of a state pass-through deduction (199A). The high revenue estimate is found on the bill's fiscal note.

² The Idaho Tax Commission estimated in December 2017 that the new pass-through deduction would cost \$30 million and on a subsequent fiscal note for House Bill 558 revised that to \$46.9 million.

³ Spence, William L. December 12, 2017. "Federal tax bill could have big implications for Idaho's state budget." *Lewiston Tribune*.

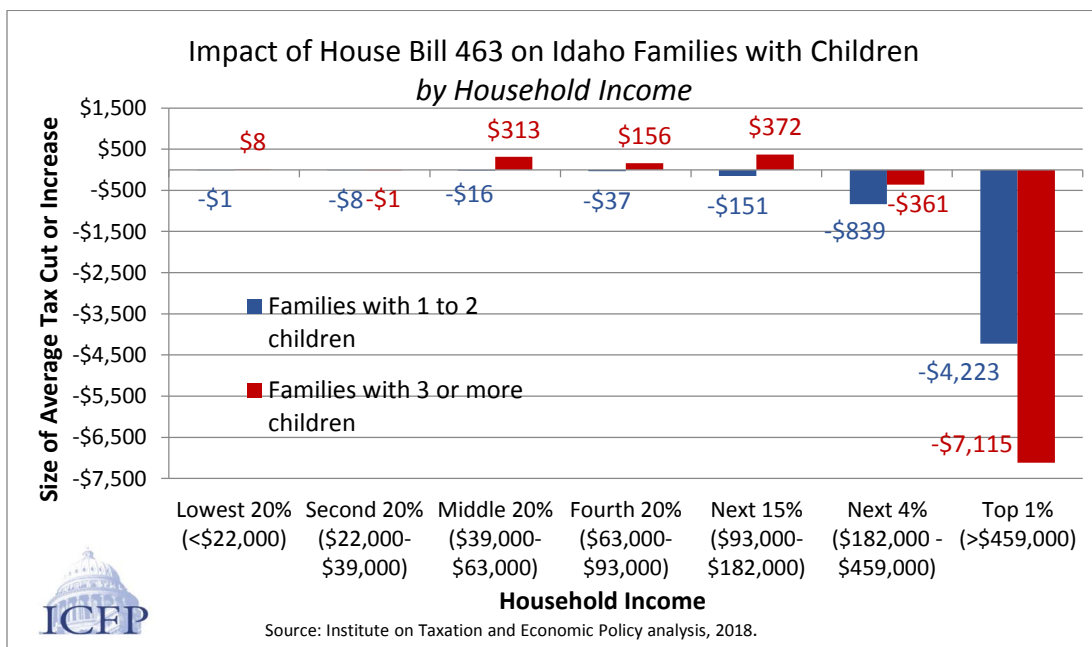
The net impact of House Bill 463 would be a general fund revenue reduction of \$105 million to \$179 million.⁴

The proposal would make four specific changes to Idaho’s tax system:

- *Conform the Idaho income tax code to changes made to the Internal Revenue Code that affect the 2018 taxable year.* The major provisions include: increasing the standard deduction and eliminating the personal and dependent exemptions, and a new state provision allowing the deduction of 20 percent of income from pass-through businesses.⁵ Some of these and additional Internal Revenue Code changes are temporary and will expire or phase-out after 2025 unless Congress acts.
- *Reduce the individual income tax rates for all brackets by a .475 of a percentage point.*
- *Reduce the corporate tax rate by .475 of a percentage point (not modeled in this analysis).*
- *Create a nonrefundable state child tax credit of \$130 per child.⁶*

This brief discusses the combined impacts of the different components of the tax proposal on Idaho households and then dissects each component separately.

Proposal Will Increase Taxes for Larger Middle-Class Families



⁴ Low estimate comes from the bill’s fiscal note. High estimate was modeled by the Institute on Taxation and Economic Policy including the new pass-through deduction.

⁵ According to the Brookings Institute, pass-through businesses - which include sole proprietorships, partnerships, and S-corporations - are not necessarily small businesses. Most hedge funds, private equity funds, law, consulting, and accounting firms are partnerships, for example, and can include publicly-traded partnerships. Other full conformity changes include limits on the state and local tax (SALT) deduction, changes to other itemized deductions, and additional business provisions.

⁶ According to the IRS, to be a qualifying child, the child must be under age 19 at the end of the year or under age 24 at the end of the year and a student, and must have lived with the claimant for more than half of the year. Provided they are younger than the claimant, children include sons and daughters, stepchildren, foster children, as well as siblings, half-siblings, and stepsiblings of the claimant, or descendants of any of them. People of any age who are permanently and totally disabled also qualify under this provision.

The combined effect of the tax changes and full conformity leaves many families with a considerable increase in tax responsibility. In particular, households with three or more children will generally pay hundreds more in taxes on average, unless their incomes are very high.

Households with an income between \$39,000 and \$63,000 and three children will end up paying \$313 more in state taxes, on average. Households with children that earn about \$459,000 or more will receive a large overall cut from the combined effect of the tax cuts and conformity. These top-earning households with one to two children will see a cut of \$4,223, and those with three children will see a cut of \$7,115, on average. The majority of the cut in this case derives primarily from the reduction in the state individual income tax rate and federal conformity, rather than the state child credit.

Impact of Full Conformity on Its Own Differs by Household Size and Income

This section analyzes the impact of full conformity in isolation. The effect of full conformity drives the disparity in gains between households with and without children in HB 463, and the disparity between smaller and larger families. Idaho households without children are more likely to see their tax bill go down due to full conformity, while households with more children are more likely to see their tax bill go up (see Appendix Charts 1 and 2).

However, households in the top 1 percent - earning \$459,000 or more - are especially likely to see their state taxes go down with full conformity. These households generally fare better because they benefit heavily from full conformity's provisions outside of the elimination of the personal exemption, such as the new 20 percent deduction on income from pass-through businesses that business owners can claim on the individual tax return.⁷

Idaho could avoid the negative impacts on working families by adopting federal changes while retaining the current personal exemption and standard deduction amounts. Idaho is among 9 states, along with the District of Columbia, that use federal definitions of the standard deduction and personal and dependent exemption.⁸ Other states have shifted to a state-defined standard deduction and a state-defined personal exemption, which shields households from changes in the federally-defined standard deduction and personal and dependent exemption.

State Income Tax Rate Reductions on Their Own Drive Uneven Gains

This section analyzes the impact of the income and corporate tax cuts in isolation. State individual income tax changes tilt the majority of the benefits of this proposal toward wealthier Idahoans. The top 1 percent – those with incomes of \$459,000 and above – would see a \$3,524 average tax cut just from a reduction in state income tax rates (see Appendix Chart 3). On top of state benefits, the wealthiest households in Idaho will also receive a cut of \$45,436, on average, on their federal tax bill.⁹

⁷ Idaho Tax Commission. 'Federal Tax reform – Idaho Impact.' Handout from presentation to the Joint Tax Committee, January 17, 2018. Other business-side provisions include allowing more small businesses to fully expense the cost of machinery and equipment rather than depreciating over time.

⁸ Tax Foundation. December 13, 2017. "Does Your State's Individual Income Tax Code Conform with the Federal Tax Code?"

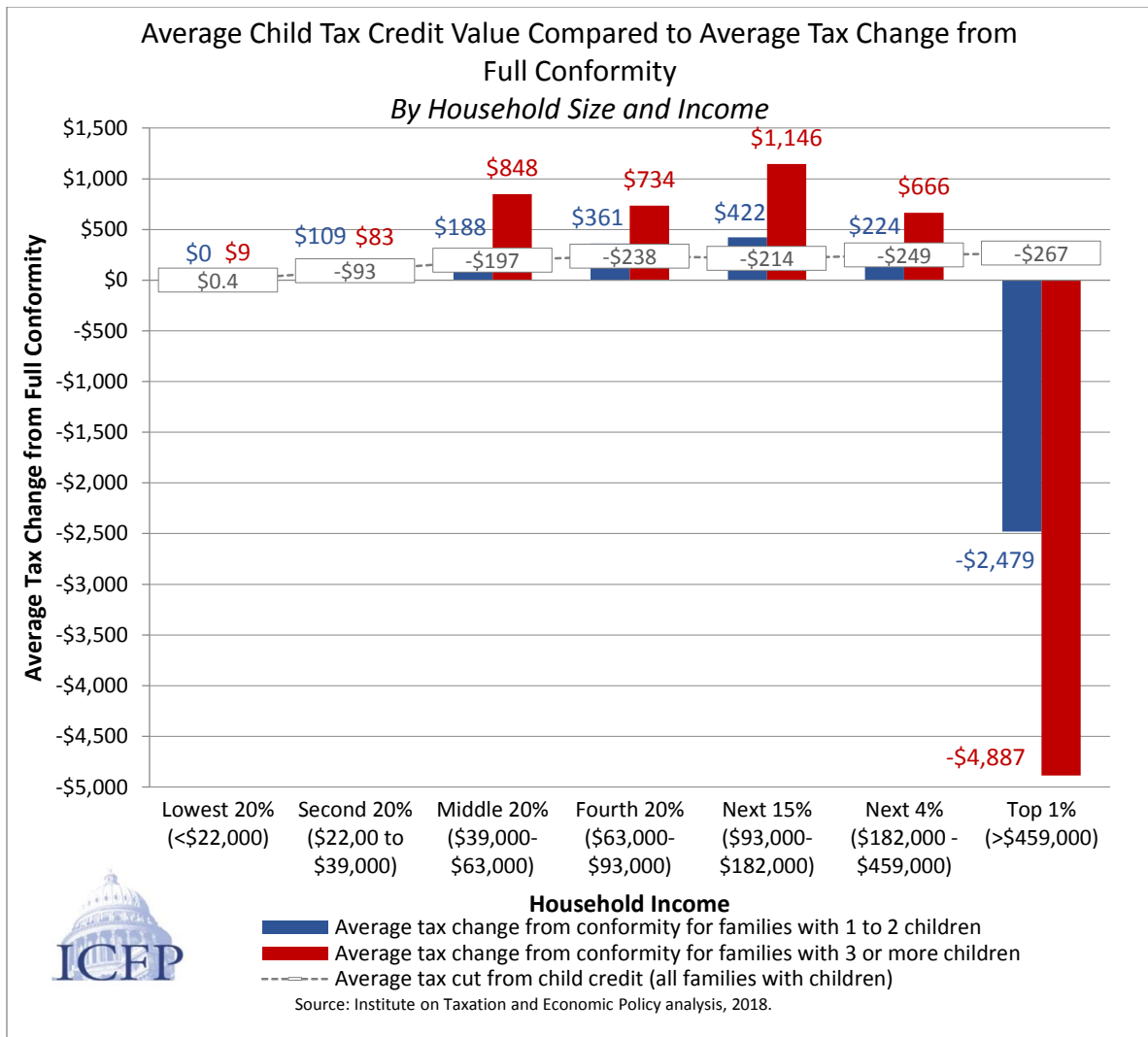
⁹ Analysis by Institute on Taxation and Economic Policy, 2018.

Idaho households with incomes between \$39,000 and \$63,000 a year would see an \$81 decrease in their tax responsibility from state income tax rate cuts, on average. Seventy-one percent of all households would see a cut in income taxes, while 29 percent would see no benefit.

State Child Tax Credit Is Not Targeted

This section analyzes the impact of the state child tax credit in isolation. Compared with average tax increases from full conformity, the average benefit of the child credit in this proposal is small (see chart below). Full conformity results in a tax increase of several hundred dollars for most households, while the value of the child credit is much lower. For households in the bottom 20 percent of the income range with children, the benefit is quite small. A nonrefundable credit means that people who owe very little or nothing on their income taxes will not be able to claim the full value of the credit, resulting in negligible benefits for households in the lowest income range.

Enacting the proposed nonrefundable child credit would reduce general fund revenue by \$47 million with 92 percent of benefits flowing to households earning more than \$39,000, on average. Since the child tax credit is nonrefundable, many families will not be able to claim the full value of the credit even if they pay a significant portion of their income in sales, excise, and/or property taxes.



Outlook: Uncertainty and Competing Pressures in Idaho’s Tax and Budget Climate

Idahoans are generally content with how the Idaho Legislature has been managing tax and budget policy and revealed high levels of satisfaction with our current tax system.¹⁰ A strong majority of Idahoans think our taxes are ‘about right.’

The fiscal year 2019 budget is tight, with many competing budget needs currently in play and many on the horizon. State government has identified a need for a new system for accounting and payroll that is estimated to cost \$102 million in the coming years.¹¹ The teacher career ladder and key related expenses are expected to cost \$46 million this year, while growing student enrollment will require an overall increase in the education budget.

At the same time, there is uncertainty surrounding multiple revenue sources. There is good reason to be cautious in predicting state revenues in the next few years. The nation has had an unusually long period of economic growth, underscoring the need to ensure that the state tax structure can weather an eventual downturn. The recently-approved federal tax cut could also prompt Congress to cut federal streams that Idaho weaves together with state resources to fund education, healthcare, infrastructure, and other services.

State revenue boosts from conformity are also highly uncertain and could easily erode over time. Taxpayers find loopholes as time progresses and taxpayer behavior can change, making it difficult to project the impacts of these provisions over time.¹² The major revenue-increasing provision in conformity –the elimination of the personal and dependent exemptions - is temporary and scheduled to expire by 2025. While conformity produces a revenue increase in 2019, it would produce a revenue loss should Idaho conform fully again when the provisions expire.

¹⁰ Boise State University School of Public Service. Idaho Public Policy Survey, 2018.

¹¹ Jani Revier. December 2017. Presentation to the Associated Taxpayers of Idaho Annual Conference.

¹² Center on Budget and Policy Priorities. January 23, 2018. “How Should States Respond to Recent Federal Tax Changes?”

Appendix

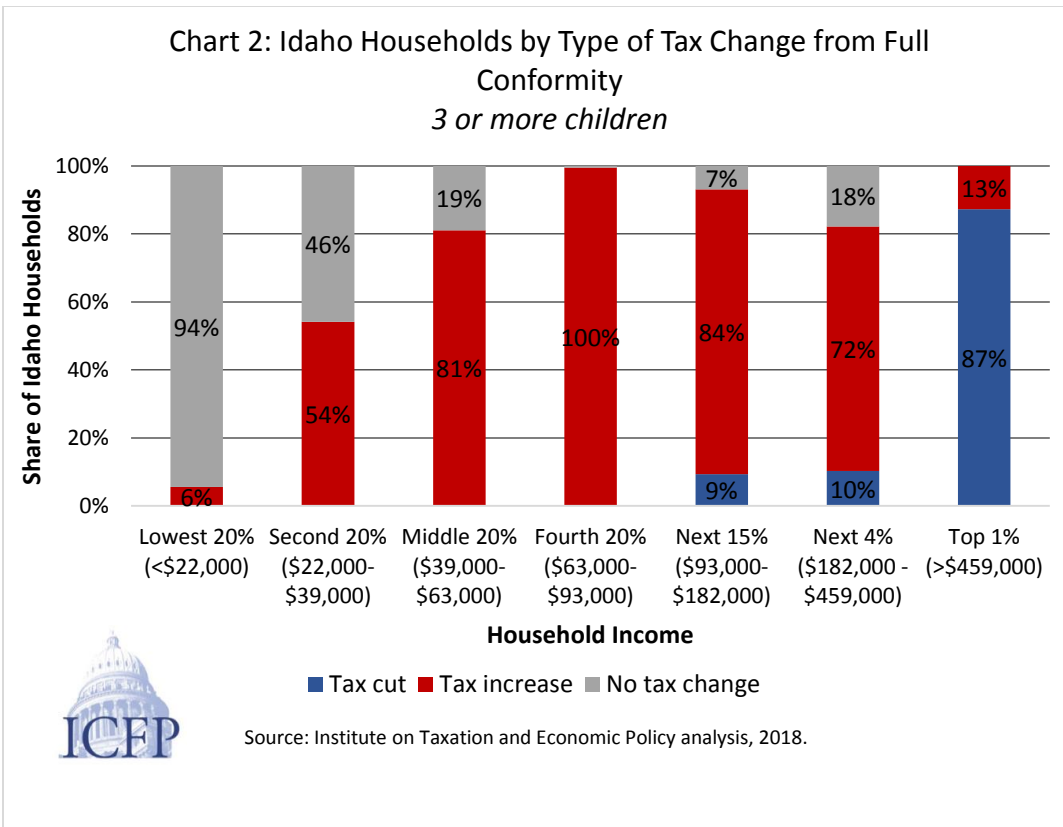
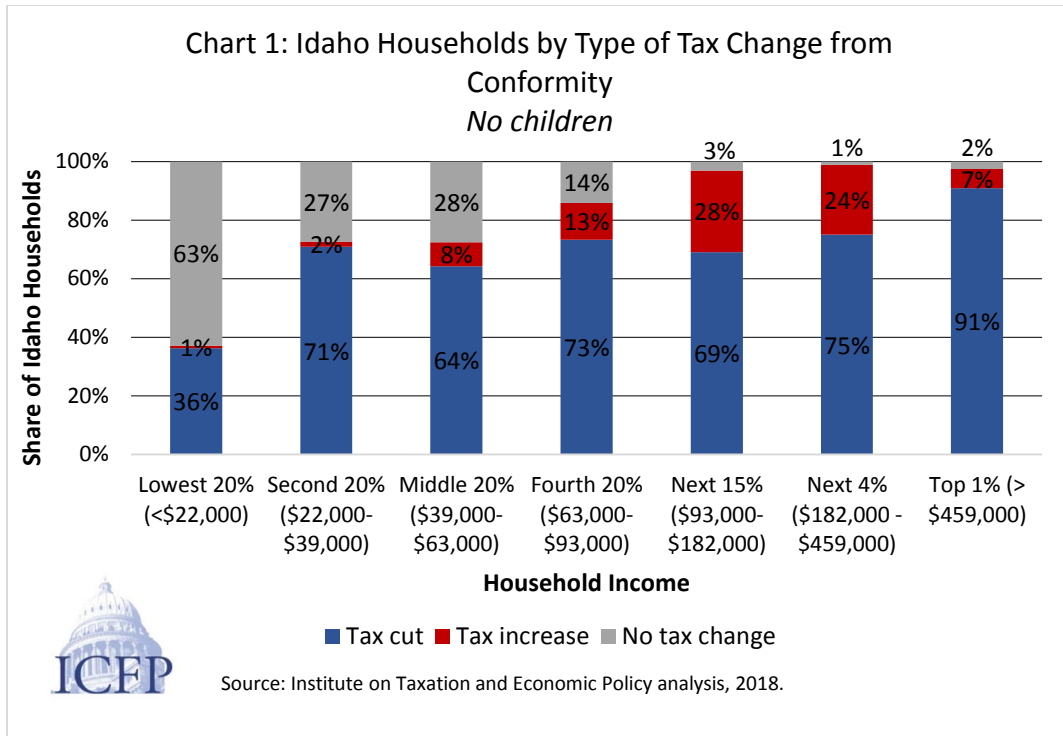
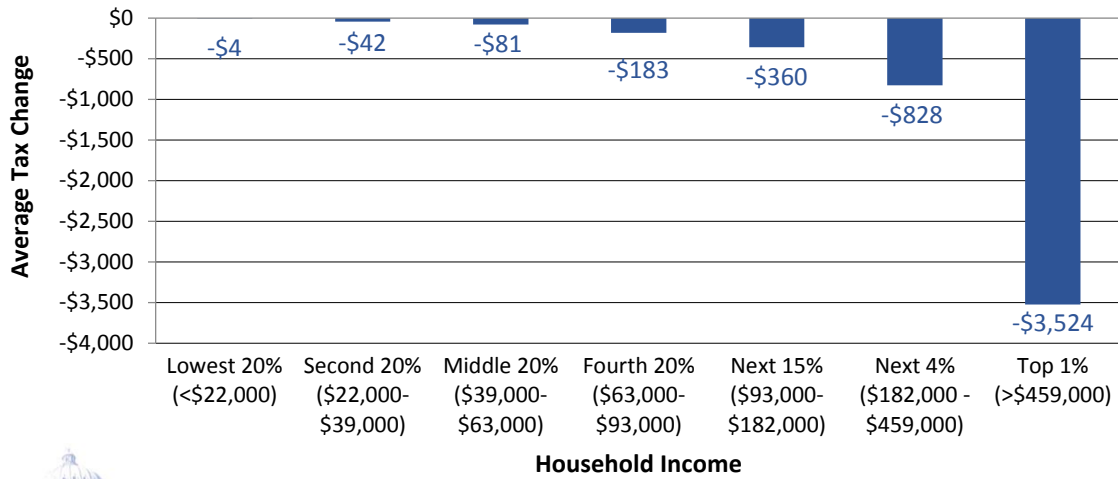


Chart 3: Impact of HB463 State Individual Income Tax Rate Reductions on Idaho Households by Household Income



Source: Institute on Taxation and Economic Policy analysis, 2018.