INDEPENDENT FISCAL OFFICE

April 24, 2018

The Honorable Patrick M. Browne
Majority Chair, Senate Appropriations Committee
281 Main Capitol Building
Harrisburg, PA 17120

Dear Senator Browne:

Thank you for your recent letter that requests the Independent Fiscal Office (IFO) to prepare an analysis of the impact on state revenues from conformity with certain federal tax code provisions. This response provides a brief description of the relevant code sections cited in your letter and how Pennsylvania tax law differs from federal tax law. The revenue estimates use both federal and state tax data to assess the impact from federal conformity. The estimates are static and do not include any potential impact that conformity with federal tax provisions might have on the state economy. All estimates are presented on a tax or calendar year basis so that relevant patterns and phase-outs are more easily shown and discussed.

IRC Section 168(k): 100% Bonus Depreciation

The Tax Cuts and Jobs Act of 2017 (TCJA) modified Internal Revenue Code (IRC) Section 168(k) to allow firms to immediately deduct or expense qualified investment (i.e., equipment) placed in service after September 27, 2017 and before January 1, 2023. Nearly all equipment purchases that have a tax life between 3 and 20 years under the Modified Accelerated Cost Recovery System (MACRS) qualify for the deduction.[1]

The 100% bonus depreciation provision encourages business investment because it reduces the effective tax rate on equipment purchases. The bonus provision does not increase total depreciation deductions, but merely accelerates when they can be claimed. For example, the bonus provision allows a $1,000 computer to be deducted from taxable income entirely in the year of purchase, but under normal MACRS depreciation, only $200 can be deducted in the year of purchase (assumes a half-year convention). The remaining $800 would be deducted from taxable income over the next five tax years as follows: $320, $192, $115, $115 and $58. For C corporations with taxable income, the larger deduction yields ($1,000 - $200) * .21 = $168 of federal tax savings for that tax

[1] The MACRS system is the method that would have been used to determine depreciation deductions if 100% bonus depreciation was not available. The system assigns a tax life to all types of business purchases of equipment and buildings. For example, a desk has a tax life of 7 years and is generally depreciated over that time period. In theory, the depreciation schedule reflects the declining economic value of the asset after purchase.

year.[2] However, future deductions that would have been claimed under MACRS are no longer claimed so that over the six-year period, the net tax savings approaches zero. Federal tax data show that the tax savings from 100% bonus depreciation for most equipment purchases (roughly 80 percent) would net out over 4 to 8 years. The revenue implications for other purchases could require up to 20 years to fully net. In this manner, 100% bonus depreciation is a timing issue and the tax savings to the firm reflects the present value of accelerated depreciation deductions that reduce current tax liability but increase it by the same amount in future years.[3]

In Pennsylvania, C corporations and pass-through entities cannot claim bonus depreciation. Therefore, the fiscal impact estimate due to federal conformity reflects the tax savings from allowing 100% bonus depreciation versus normal MACRS depreciation.[4] For the purpose of the estimate, partial-year 100% bonus depreciation available for tax year 2017 is disregarded. Based on data from Pennsylvania corporate net income tax (CNIT) returns for tax year 2015, the CNIT revenue impact estimate is as follows (tax year basis):[5]

- 2018 -$390 million
- 2019 -$330 million
- 2020 -$290 million
- 2021 -$270 million
- 2022 -$250 million

Under the TCJA, bonus depreciation is phased-down to 80% for tax year 2023, then 60%, 40% and 20% over the next three tax years. For tax year 2024, the analysis projects that the net CNIT revenue impact would turn positive and remain so over the next decade.

For pass-through entities (S corporations, partnerships and sole proprietors), there are less data that can be used to derive a revenue impact estimate because those firms do not report the "add back" of federal bonus depreciation on the Pennsylvania tax return. Therefore, the estimate pro-rates national amounts to Pennsylvania. The analysis assumes that 3.9 percent of the total U.S. bonus depreciation amount for sole proprietors (federal Schedule C) and 3.1 percent for S

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[2] The 21 percent figure used in the formula is equal to the federal corporate income tax rate.

[3] Although bonus depreciation does not increase total deductions, the tax savings in present value terms can still be significant. For example, a $1 million investment with a tax life of 10 years would realize $34,160 of tax savings under 100% bonus depreciation assuming (1) a discount rate of 5 percent and (2) the full deduction is used to offset taxable income in the year it is claimed.

[4] Prior to the TCJA of 2017, federal bonus depreciation was scheduled to decline from 50% in 2017 to 40% in 2018, 30% in 2019, and then eliminated for future tax years. For simplicity, the fiscal impact estimate represents the difference between 100% bonus depreciation and normal MACRS deductions. The true fiscal impact estimate would be slightly higher for tax year 2018 due to Pennsylvania's imperfect add back mechanism that effectively reduces regular MACRS deductions if federal bonus depreciation exceeds 30%. Moreover, Corporate Tax Bulletin 2017-02 denies any depreciation deductions for state tax purposes for firms that claim 100% federal bonus depreciation. Those deductions cannot be claimed until the property is sold or disposed. If the bulletin treatment was considered the baseline or counterfactual scenario, then the revenue impact from federal conformity would be considerably higher. Legislation is pending that will allow regular MACRS depreciation for state income tax purposes for firms that claim 100% bonus depreciation.

[5] C corporations report the amount of 50% bonus depreciation they must "add back" because it is disallowed under Pennsylvania tax law. The estimate uses that amount, plus other relevant information from the tax return (e.g., apportionment factors) to derive the revenue impact estimate. A small increase was also applied because 100% bonus depreciation applies to used equipment that is new to a taxpayer. Under 50% bonus depreciation, used equipment purchases did not qualify for bonus treatment.

corporations/partnerships is attributable to Pennsylvania firms. Those percentages are based on the share of taxable income reported on the federal personal income tax return by Pennsylvania residents for those entity types. Based on federal data for tax year 2015, the analysis estimates that Pennsylvania firms claimed $3.9 billion of 50% bonus depreciation deductions for tax year 2015. That amount is grown to tax year 2018 and doubled to reflect 100% bonus depreciation. The analysis assumes that a portion of those much larger deductions would not effectively offset taxable income (i.e., would only serve to increase losses) in the year claimed, and under current tax law, the losses could not be carried forward. The analysis projects the following impact on personal income tax (PIT) revenues from pass-through conformity with federal 100% bonus depreciation (tax year basis):

- 2018 -$130 million
- 2019 -$105 million
- 2020 -$85 million
- 2021 -$75 million
- 2022 -$55 million

Beginning in tax year 2023, bonus depreciation is phased-down to 80%, then 60%, 40% and 20% over the next three years. For tax year 2024, the analysis projects that the net PIT revenue impact would turn positive and remain so over the next decade.

IRC Section 179: Expensing for Certain Small Businesses

The TCJA of 2017 raised the IRC Section 179 maximum deduction threshold from $510,000 in tax year 2017 to $1 million for tax year 2018. The deduction limit then increases with inflation for future tax years. The provision allows certain businesses to expense or immediately deduct qualified equipment purchases up to $1 million. The deduction is phased-out dollar for dollar for qualified purchases that exceed $2.5 million. Hence, a business with $3.5 million of qualified purchases cannot claim a deduction under IRC Section 179. For tax year 2014, the average Section 179 deduction claimed on all federal returns was as follows: C corporations, $54,460; S corporations, $37,210; partnerships, $42,530, and sole proprietors, $8,160. For that year, the maximum deduction was limited to $500,000.

Although there are certain technical differences in how the provisions are applied, Section 179 and 100% bonus depreciation essentially allow firms to accomplish the same objective: reduce taxable income through the immediate deduction of qualified investment in the year it is placed in service. For tax years 2018 to 2022, the provisions are redundant for certain firms. Prior to 100% bonus depreciation, taxpayers with property eligible for both provisions were required to use Section 179 first, then bonus depreciation for any residual basis, then regular depreciation. This analysis assumes that if firms qualify for the Section 179 deduction, they will maximize the use of that provision and then use 100% bonus depreciation for any basis that remains.

In Pennsylvania, C corporations can claim a Section 179 deduction as per federal law, but pass-through entities such as S corporations, partnerships and sole proprietors can only claim up to $25,000. Based on federal income tax return data for Pennsylvania firms for tax year 2015, the

analysis projects that conformity with federal tax law would have the following impact on PIT revenues for tax years 2018 to 2022[6]:

- 2018 -$65 million
- 2019 -$45 million
- 2020 -$33 million
- 2021 -$25 million
- 2022 -$19 million

For tax year 2018, the analysis projects that many firms could receive an average PIT cut of $2,000 to $3,000. In general, S corporations and partnerships would receive a larger average tax reduction, and sole proprietors a smaller one. Conformity would also simplify the tax code for smaller firms because separate computations would not be necessary for the state and federal income tax return. Similar to bonus depreciation, the revenue impact from Section 179 conformity declines in future years because the provision merely accelerates deductions and does not increase total deductions over the life of the property. However, the provision is a permanent part of the tax code and does not expire, and therefore conformity continues to have a modest negative revenue impact in all future years.

IRC Section 1031: Non-recognition of Gain from the Exchange of Certain Property (Like-Kind Exchanges)

In the ordinary course of business, firms may directly exchange, as opposed to sell, business assets with other firms or use qualified intermediators to facilitate exchanges. For example, a firm might exchange used vehicles for new vehicles. Alternatively, firms could exchange land and buildings in order to expand business operations into new territories. Individuals might also exchange rental properties located in different cities or states. Similar to the sale of assets, an exchange of business property will often generate a capital gain. A firm generates a capital gain if the consideration received from exchange of the asset exceeds the remaining basis, or the amount of depreciable value that remains to be deducted against future federal taxable income. That amount is equal to the original purchase price of the asset less the depreciation deductions already used to reduce taxable income since the original purchase.

If a firm realizes a capital gain upon the sale or exchange of a business asset, then the firm must declare the gain as income on the federal income tax return. An exception to this rule is an exchange of business property that is "like-kind" in nature. IRC Section 1031 provides that a firm may defer reporting a capital gain for like-kind property that is exchanged and used in the course of business. Business property can receive like-kind treatment if the assets exchanged are of like kind, which includes assets of a like class (i.e., in the same general asset class or the same product class) or like character. The exchange of real estate assets generally qualifies as a like-kind exchange, and the exchanged real estate need not be located in the same state. Like-kind tax

[6] The TCJA also raised the deduction limits for passenger vehicles used for business purposes. Prior to the TCJA, the first-year deduction for such vehicles was limited to $11,160 regardless of the depreciation method used. For tax year 2018, the first-year limit is increased to $18,000. For SUVs and trucks used for business purposes, the Section 179 deduction limit was $25,000, and any residual basis could be further depreciated under 50% bonus and regular depreciation. For tax year 2018, those vehicles can be fully expensed due to 100% bonus depreciation, despite the $25,000 limit on deductions claimed through IRC Section 179.

treatment is specifically disallowed for the exchange of inventory, stocks, bonds and other securities.

For Pennsylvania PIT, Section 1031 gains cannot be deferred. In a *Tax Update* from September 2015 (Number 181), the Pennsylvania Department of Revenue notes the following regarding the deferral of gains under IRC Section 1031: "The gain on the transaction must be recognized for Pennsylvania personal income tax purposes and included when calculating Pennsylvania taxable income. Because the gain must be recognized for state tax purposes, there will be different depreciable federal and Pennsylvania bases."

In response to a legislative request, the IFO recently examined the revenue impact from non-conformity with this federal provision.[7] Pennsylvania does not conform to IRC Section 1031 federal rules for PIT, but does conform for CNIT. In the previous analysis (June 2017), the IFO estimated that federal conformity could reduce PIT revenues by $40 to $60 million per annum. That estimate was applicable for tax law effective prior to the TCJA of 2017. The act limited the non-recognition of gains to real property only for exchanges completed after December 31, 2017. Therefore, the section generally applies to exchanges of real estate, buildings and equipment that is permanently attached to the land or building. Studies have found that roughly 80 percent of the dollar value of Section 1031 exchanges were real property, split equally between residential rental properties and business real estate. Assuming that percentage remains accurate, then the previous IFO revenue estimate could be reduced by 20 percent to reflect current law under the TCJA.

Net Operating Loss Deductions for Pass-Through Entities

The TCJA of 2017 enacted new restrictions that impact non-corporate net operating losses (NOLs) for federal income tax purposes. Although losses from one business can still fully offset income from another, taxpayers cannot use business NOLs to offset more than $500,000 (married filing joint) or $250,000 (single) of non-business income in a given tax year. Unused NOLs above that amount are termed "excess business losses" and can be carried forward indefinitely and used to offset future business and non-business income. However, NOL carryforwards can only offset up to 80 percent of future taxable income. These rules apply to tax losses generated in tax year 2018 to tax year 2025. After 2025, the NOL rules revert to pre-TCJA law.

The Pennsylvania PIT code only allows business losses to offset gains in the same class of income for the same tax year. The losses cannot be used to offset other forms of income, nor can they be carried forward to future tax years. The federal tax code makes a distinction between passive and active losses, and passive losses may only generally be used to offset passive income, either in the year generated or if the loss is carried forward.[8] Those restrictions would also apply if Pennsylvania conformed to the federal tax code. Data are not available to estimate the share of Pennsylvania losses that would qualify as passive. At the federal level, a study by the U.S. Department of the Treasury finds that 21.4 percent of partnership losses and 6.9 percent of S corporation losses were

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[7] IFO letter to Representatives O'Neill and Bloom, June 30, 2017.

[8] For federal tax purposes, a passive activity is any rental activity or any business in which the taxpayer does not materially participate. Non-passive activity are businesses in which the taxpayer works on a regular, continuous and substantial basis. For further information, see https://www.irs.gov/publications/p925.

passive for tax year 2007.[9] The weighted average for both partners and shareholders was 15.1 percent. This analysis assumes that 15 percent of net profits losses and all rental losses would be classified as passive and therefore could only be used to offset other passive or rental income in future years.[10]

For tax year 2015, PIT data reveal there were $4.82 billion of unused net profits losses and $2.53 billion of unused rental income losses. If all losses could be used immediately to offset taxable income, then PIT revenues would decline by $226 million ($7.35 billion * 0.0307). However, only a portion could be used immediately because insufficient taxable income is available to absorb all loss income. A simulation using the tax year 2015 PIT micro data shows that a maximum of $1.71 billion of net profits NOLs and $1.10 billion of rental NOLs could be used in that year to offset other taxable income. If the $500,000/$250,000 TCJA caps are also applied, then those amounts decline by roughly 5 percent.

Based on these federal and state tax data, the analysis reduces the maximum amount of net profits NOLs that could be used to offset other taxable income in the year the NOL was generated by 20 percent to reflect the impact of (1) passive loss restrictions and (2) the new TCJA thresholds. The application of that cut back to the maximum dollar amount of net profits NOLs that could offset other taxable income suggests that $1.37 billion ($1.71 billion * 0.8) of net profits NOLs (28.4 percent of total amount generated that year) could be used for that purpose in tax year 2015. Net profits NOLs are grown to tax year 2018 (3.0 percent per annum) and the following pattern of NOL utilization is assumed: 28.4 percent used to offset taxable income in the tax year generated, 20 percent used in the next tax year, then 15 percent, 12 percent and 10 percent. In this manner, roughly 85 percent of the original net profits NOLs generated in tax year 2018 are assumed to offset taxable income in that tax year or the subsequent four tax years. It is noted that data were not available to inform this utilization pattern, and the actual pattern could be quite different from what is assumed in this analysis.

Based on these assumptions, the analysis estimates the following impact on PIT revenues from conformity to federal tax treatment of net profits NOLs (tax year basis):

- 2018 -$45 million
- 2019 -$80 million
- 2020 -$105 million
- 2021 -$130 million
- 2022 -$150 million

By tax year 2022, the revenue impact is largely fully phased in, and would increase in future years with the underlying growth rate in net profits NOLs.

For rental NOLs, the analysis assumes that all losses are passive and can only be used to offset future rental income or passive net profits gains. The analysis assumes the following NOL utilization pattern: 5 percent (year generated), 20 percent, 20 percent, 20 percent and 10 percent. In this manner, 75 percent of the original rental NOLs are used to offset taxable income over five

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[9] See "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, U.S. Department of the Treasury, Working Paper Number 4 (August 2011).

[10] Net profits corresponds to line 4 on Form PA-40 and rental income is included on line 6, which also includes income from royalties, patents and copyrights. However, virtually all negative amounts reported on line 6 are due to rental income losses.

tax years. It is noted that data were not available to inform this pattern and the actual pattern could be quite different from what is assumed in this analysis.

Based on these assumptions, the analysis estimates the following impact on PIT revenues from conformity with federal tax treatment of rental NOLs (tax year basis):

- 2018 -$4 million
- 2019 -$21 million
- 2020 -$39 million
- 2021 -$57 million
- 2022 -$67 million

By tax year 2022, the revenue impact is largely fully phased in, and would generally increase in future years with the underlying growth rate in rental NOLs.

One-Half Federal Self-Employment Tax

The Pennsylvania PIT does not allow a deduction for one-half of the self-employment tax, commonly referred to as SECA (Self-Employed Contributions Act). This deduction is permitted on the federal income tax return (line 27) and allows self-employed individuals to deduct what is essentially the employer's share of the Old Age, Survivors and Disabled Insurance (OASDI) tax and the Hospital Insurance (HI) tax. The most recent data from the Pennsylvania federal income tax return (tax year 2015) show that 647,880 filers reported total SECA tax of $2.09 billion. The analysis assumes that amount grows to $2.25 billion for tax year 2018. If the deduction is equal to one-half that amount, then PIT revenues would decline by $2.25 billion * 0.5 * 0.0307 = $35 million. The effective revenue impact would be smaller because some self-employed individuals report tax losses and could not use the new deduction to offset taxable income in that year.

Self-Employed Health Insurance Costs

The Pennsylvania PIT does not allow a deduction for health insurance costs of the self-employed. At the federal level, self-employed individuals may deduct (line 29) amounts paid for health insurance for the filer, their spouse and children. The insurance plan must be established under the business and the filer's personal services must be a material income-producing factor in the business. For tax year 2015, 171,850 Pennsylvania federal income tax filers claimed $1.22 billion in deductions. The analysis assumes those deductions grow to $1.38 billion for tax year 2018. If that amount was allowed as a deduction, then PIT revenues would decline by $42 million ($1.38 billion * 0.0307). The effective revenue impact would be smaller because some self-employed individuals report tax losses and could not use the new deduction to offset taxable income in that year.

New Deduction for Certain Qualified Business Income of Pass-Through Entities

The TCJA of 2017 created a new deduction up to 20 percent of the income from certain pass-through businesses.[11] The size of the new deduction will vary based on the nature of the business activity, total income of the owner and possibly other criteria, such as how much the business pays its employees. The TCJA divides businesses into two groups: specified (or personal) services (e.g., law firms, medical providers, consulting) and all other businesses.[12] Owners are then further separated into three groups based on filing status and total taxable income:

- Singles reporting less than $157,000 or joint filers reporting less than $315,000 may take the full 20 percent deduction on the pass-through income regardless of whether the income is from a personal service business.
- Singles reporting more than $207,500 or joint filers reporting more than $415,000 are subject to different rules. Personal services firms do not get a deduction. If other pass-through businesses are owned, then the deduction may be limited (or even eliminated) based on the amount of wages the business pays to employees and the property it owns.
- Those with income between the thresholds are eligible for a partial benefit depending on various criteria.

In order to estimate the impact from federal conformity with this new provision, the following data were used and assumptions made:

- For net profits on the PIT return (2015 data), filers reporting positive amounts ($39.2 billion) were separated into (1) married filing joint and all other filing categories and (2) four taxable income groups: less than $157,000, $157,000 to $315,000, $315,000 to $415,000 and greater than $415,000.[13]
- Various state and federal data were used to estimate the share of pass-through business income that is attributable to a "specified service trade or business." For the lowest of the four income categories, that share is assumed to be 25 percent. For the other three, it is assumed to be 35 percent.
- For married filers with less than $315,000 of taxable income, all pass-through business income qualifies for the new deduction, regardless of the source. For married filers with taxable income over $415,000, no personal service income can qualify and the analysis assumes that 50 percent of other business income qualifies. For amounts between $315,000 and $415,000, the analysis assumes that 50 percent of personal service and 75 percent of other business income qualifies.
- For single/other filers with less than $157,000 of taxable income, all pass-through business income qualifies for the new deduction, regardless of the source. For single/other filers with taxable income over $207,500, no personal service income can qualify and the

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[11] The description that follows is borrowed from the Tax Policy Center: http://www.taxpolicycenter.org/taxvox/navigating-tcjas-pass-through-deduction-0.

[12] A specified service trade or business is any business that involves the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners." Engineering and architecture services are excluded. The definition also includes a business where the performance of services consists of investing and investment management trading, or dealing in securities, partnership interests, or commodities.

[13] It is noted that Pennsylvania taxable income will not correspond exactly with federal taxable income due to deductions allowed or income included at the federal level.

analysis assumes that 50 percent of other business income qualifies. For amounts between $157,000 and $207,500, the analysis assumes that 50 percent of personal service and 75 percent of other business income qualifies.

It is emphasized that the rules for the new pass-through deduction are complex and insufficient data are available to model all aspects of the provision. The estimate is based on relatively solid data for business income reported by those with taxable income under $157,000 for singles and $315,000 for married filing joint. Overall, 41 percent of all Pennsylvania pass-through income falls under those thresholds and should qualify for the full 20 percent deduction regardless of the source. The remainder of the estimate is based on assumptions regarding (1) the share of income that qualifies as specified or personal service (35 percent) and (2) the impact of restrictions based on a two-part formula that uses wages paid to employees of the firm and the basis of a firm's qualified property for filers with taxable income that exceeds thresholds. Data are not available to model the impact of the wage and qualified property restrictions on the 20 percent pass-through deduction.

For tax year 2015, the total amount of positive net profits reported on the PIT return was $39.2 billion. If all net profits income qualified for the 20 percent deduction, then PIT revenues would decline by $241 million ($39.2 billion * 0.20 * 0.0307). Based on the above assumptions, the analysis assumes that roughly 75 to 80 percent of total net profits would qualify for all or some portion of the deduction. For tax year 2018, the analysis estimates that the new deduction applied to net profits income could reduce PIT revenues by $140 to $160 million. The estimate is static and does not attempt to reflect any behavior that may occur in response to the new tax law. For example, firms or individuals will attempt to recharacterize income in a manner so that it qualifies for the new deduction.

The new deduction also applies to rental income. Unfortunately, rental income is not reported separately on the Pennsylvania income tax return, but is reported with royalty, copyright and patent income. The analysis assumes that rental income comprises 75 percent of that field and that none of it is specified or personal service income. Using similar assumptions as those used for net profits, the analysis estimates that the new deduction for rental income could reduce PIT revenues by $25 to $30 million for tax year 2018.

Unreimbursed Expenses Subject to the Two Percent Floor

Under IRC Section 67, miscellaneous itemized deductions claimed on the federal income tax return for a given year are only allowed to the extent that the aggregate of such deductions exceeds 2.0 percent of adjusted gross income. Miscellaneous itemized deductions are reported on federal Schedule A and include various unreimbursed employee expenses, tax preparation fees and other miscellaneous expenses incurred to collect or produce income.[14] The TCJA eliminates those deductions beginning with tax year 2018.

Pennsylvania allows a similar deduction for certain expenses. For Pennsylvania PIT purposes, filers may deduct unreimbursed employee business expenses on line 1b of the state income tax return. For tax year 2015, filers claimed $2.11 billion in unreimbursed expenses. Assuming those

[14] For a discussion of these expenses, see IRS Publication 529.

amounts increase by 3.0 percent per annum, the elimination of that deduction implies an increase in PIT revenues of $71 million for tax year 2018.

Unfortunately, for certain smaller IRC provisions requested in the letter, it was not possible to estimate the fiscal impact from federal conformity because data were not available for that purpose. Those provisions include:

- IRC Section 1042 non-recognition of gain from sales of stock to employee stock ownership plans or certain cooperatives.
- IRC Section 1202 exclusion of gain on qualified small business stock.
- IRC Section 1244 losses on small business stock.

I hope this information is useful and responsive to your request. If you have any questions regarding the contents of this analysis, please do not hesitate to contact my office (717-230-8293). Per the policy of the office, this response will be posted to the IFO website three business days after transmittal to your office.

Sincerely,

Matthew J. Knittel
Director, Independent Fiscal Office