Nikki Dobay (00:00):

Hello and welcome to GeTtin' SALTy State and Local Tax Policy podcast hosted by Greenberg Traurig. My name is Nikki Dobay, shareholder in the Portland, Oregon and Sacramento, California offices. Very pleased today to have a regular back on the show. Jared Walczak vice President of State Projects at the Tax Foundation. Jared, I will give you a new title later in the podcast at some point, I promise. But thank you so much for being here today. Always a pleasure.

Jared Walczak (00:28):

Well, thank you for having me.

Nikki Dobay (00:31):

And I don't know if our listeners are aware, but there was this little bill that passed in Washington. Washington DC that is, a few weeks ago. Actually, just a week ago. It was signed, and so we are going to talk about that. That little bill. I'm going to call it the little bill throughout. You could correct me if you think that's wrong. And where we're really going to spend our time is high level overview of what the bill does and then what is going to happen at the state level, what we're looking at later this year. So Jared, tell us what the heck happened in Washington last week.

Jared Walczak (01:07):

Can any of us really say that? You keep referring to this little bill and I've been reliably informed that this is a one big and beautiful bill, and I'll tell you that I've heard a lot of people question the beautiful, but you may be the first to question the big.

Nikki Dobay (01:24):

Oh, right. All right. I stand corrected. Thank you for that as always.

Jared Walczak (01:29):

Yeah. This is certainly a significant bill. It's significant in a lot of ways and obviously we're not going to go into all of those. Because I think we're focused on the state implications really state tax implications and there's so much more it does. But this is a significant bill because it changes the federal tax code in a variety of ways that flow through directly to states. There are implications for state budgets because there are changes in transfers to states. That's going to affect states. There's implications because it restricts in one case the taxing authority of states, and that's really specific to something called provider taxes. But then it's also significant because the federal tax code itself changes in a lot of ways that can be incorporated sometimes automatically in many states, and then policymakers will have to decide do they want to follow those provisions? Do they want to decouple from them? My view is that it should be case by case. That some of these are really good provisions that states should be conforming to, and there are others where policymakers might reasonably ask, why are we doing this? Maybe we should decouple from certain provisions.

Nikki Dobay (02:34):

All right. So a couple buckets there. So where do you want to start the conversation and get a little more in the weeds about the state impacts of this? From my perspective, it seems like the biggest impact is on the budgetary implications that this may have for states. Back in 2017 when the TCJA passed there, it was all about conformity because there were so many changes to the internal revenue code. But my sense with this bill is that it's going to hit the states much more on the budgetary side with what they may be losing.

Jared Walczak (03:11):

You're right that not as much is changing in the federal tax code, but the discrete changes are still significant for states. The other difference between this and the Tax Custom Jobs act from a state perspective is the TCJA mainly broadened the tax base from a state's perspective. We often talk about this looking back as this $1.5 trillion tax cut over a 10-year budget window. Really, you can think of it as about a $6 trillion cut in the rates offset by about a $4.5 trillion expansion in the tax base, and the states got the benefit of some, not all, but some of that expansion and of course the rates didn't trickle down to them. So it was revenue generating for states. That is not generally the case with the OBBB or however we choose to call it this little bill as you say. There are some provisions that are revenue expanders, but on the whole they are reducing revenues for states and that's why I think a lot of states are going to have this conversation.

Nikki Dobay (04:14):

Okay. So sticking with conformity then, what are the provisions that you're most focused on and spending your time as we're talking to policy makers later this year about what they potentially need to conform to or to couple from. Where you focused?

Jared Walczak (04:33):

Yeah. So let me put this into a few buckets. There are some of the new provisions, some of them are temporary that I think of as economically not terribly significant. They're not pro-growth. They're somewhat arbitrary. Maybe even a little capricious. And they're cost drivers for states, they'll reduce revenue. This is things like the deduction for auto loan interest or the deduction for qualified tips or for overtime premium pay. They're poorly targeted. Take tips for instance. Even if you're trying to help low income taxpayers, it's true that most taxpayers who earn tips are lower income, but the vast majority of low income taxpayers are not tipped workers. It's not well targeted. These things are costs. They can flow through to some states mostly just those that begin with federal taxable income. So it's not the majority of states. But if it's hitting your budget, you might ask, why are we doing this? Is it really worth this cost? And you could easily see states say, "Hey, we know there's a benefit to conforming." I'm going to make the case there's a strong benefit to being up-to-date on your conformity, matching the federal government generally. But you can make modifications and you might say, "We're adding this one back. We don't really think these provisions are that valuable."

(05:48):

Then there are on the business side, the expensing provisions. This is the restoration of 100% full expensing for certain capital expenditures under 168(k). That a hundred percent bonus depreciation. It's the new expensing for certain structures. Basically you can think of that as manufacturing. This is factories. That's brand new and this would be offered and then there's a restoration. It always used to be that research and development or technically research and experimentation expenses were immediately deductible and as a pay for in the back half of the TCJ's 10-year window, that changed. It became this five-year amortization. I don't think members of Congress ever really wanted that to happen, but a bit of a budget gimmick, they hoped it would be fixed and it wasn't fixed on time. It is permanently fixed here. That flows through to states as well.

(06:42):

The full expensing, the bonus depreciation flows through to about 15 states because those are the ones that follow the federal government on this. There's some states that just automatically are at a hundred percent. There's some states that decouple things like R&E, things like the new structures. Pretty much every state would bring those in unless they make a change. I think of these as good policy. This is what tax code is supposed to do. So I would hope states conform to this and that they remember that say for R&D, this is what they always did. Yes, they've had a few years of not doing it, but this is what they always did previously. So it's not some radical new thing that they haven't accounted for. And then there's the shift from GILTI to NCTI that affects certain states and I'm sure we'll get into that, but that is a bit of a mess for states.

Nikki Dobay (07:25):

Yeah. Let's put a pin in that. I think what's going to be the challenge for policymakers on the two buckets you talked about ... And I'll just say the word out loud. I think that on the individual side we have some gimmicky short-term deductions that the states probably should stay away from, but I worry that there's going to be some states that just can't resist the gimmick. And then there's going to be the, well, it's better to conform, so we should just pick these up. I completely agree with your policy reasons. I think the state should probably try to hold their arm out, but we know how it goes with residents vote and businesses don't. So I hope that the policymakers at the state level stay strong to some good policy measures and do follow the recommendations you've made.

(08:16):

So what about the budgets, the budget issues that states are going to face? Have you all done any analysis of the final package? And I understand it's only been a week and you need to sleep, but where is the economics of this falling out? How badly are the states going to be hit by these changes to Medicare and SNAP and some of those other provisions?

Jared Walczak (08:46):

These are all meaningful and policymakers are going to think carefully about them. I want to emphasize it is not a crisis from the state's perspective and that also some these provisions will phase in or be implemented over time. For instance, on SNAP, this is significant. For the first time, states are being asked to engage in cost sharing where they would bear a portion of the cost of the administration of SNAP. They would also then bear a portion for the first time of the cost of the food benefits and how much of that benefit would depend on how high their error rate is, the erroneous payments rate. In the house version where they went up to 25% share, we did run the numbers and we saw that based on current error rates, states would potentially be picking up about 22, almost 23 billion a year across the country.

(09:41):

The Senate version is not as stringent with regards to states. We have not done a new estimate. I'm thinking it's in the ballpark of 15 to 17 billion, but that's still real money. What's important is that it also depends on your error rate in the sense that if states respond to this over the next couple of years by implementing new mechanisms to have lower rates of over erroneous payment, not only does that reduced costs, it not making erroneous payments, but also the share is lower. So it may be lower than those numbers, but still we're talking billions of dollars. It is across all states and it begins in 2027, January 1st, 2027. States don't need to go to the specialist session over this because they can take it up next year, but they're going to be thinking about that expense.

(10:29):

On Medicaid there's two different elements of this. One I think the one most people are thinking about with Medicaid because it's the big issue is the work requirements. And those work requirements will result in reduced enrollment. Different estimates of how many people would be off the road, but certainly reduced enrollments and some administrative costs of actually trying to enforce these requirements. So states are grappling with what are those costs, but also do we want to have this reduced enrollment? If they go along with the federal government, this is a significant savings for them because they're paying out fewer Medicaid claims. Of course, some states aren't going to do that, and some states at least presumably are going to say, "We don't want this." And the federal government's not going to provide a match for these individuals anymore. If we're creating a parallel program within our Medicaid services and paying a hundred percent, that's a real cost and that's a policy decision the states will have to make. But I think you're going to see some states decide to take on this additional burden. That's a significant cost.

(11:37):

The other more direct tax cost is something called provider taxes. Some people know what these are. I don't want to assume even on a tax podcast that everyone knows what these are. Here's the interesting thing. They're stupid and they're important. No one would defend these on the merits.

Nikki Dobay (11:58):

I love that.

Jared Walczak (11:59):

No one would say this is how you want to create a system. Essentially go back to 1989 and New Hampshire, the governor has this brilliant insight. Okay, we get federal matching dollars on our Medicaid spend. It varies how much based on state characteristics, but the federal government is in a matching program with states where they share these funds. So the more the state spends on Medicaid, the more federal dollars you get through that FMAP. So what if you could create a little bit of a shell game where it looked like you're spending more than you actually are? What if for instance, you put a new tax on all of your Medicaid service providers with the promise that don't worry, we're just going to give it all right back to you. Nothing's really changing. We tax you, we collect money, we pay it right back to you, but when we pay it back to you, it's Medicaid spending. Then we can get a match from the federal government on that. And it's brilliant because it doesn't cost the state anything. It's not actually new spending for them and you get a match. The federal government ultimately had to say that's got to be capped in some way. So there was a decision years ago, it couldn't be more than 6% of your Medicaid expenditures. There's a more complex formula, but basically it's 6%. There's also some uniformity requirements, some other provisions here.

(13:20):

In this new bill that will phase down starting in fiscal 2028, and going through fiscal 2032 from 6% to a three and a half percent cap for states that have expanded Medicaid. For the I believe 10 states that haven't they can be grandfathered in, retain their 6%. I guess the idea is that they're getting the ordinary match, they're not getting that 90% special match on the expanded population. But they can maintain whatever they have now, but they can't add new, and obviously you can't go above six. You never could. The other states will have to phase down to three point a half percent, which is a reduction in the benefit they get. It is going to be a new cost for states. And no one would've ever said this was an ideal way to generate revenue to get a transfer from the federal government, but states have relied on it for years and it'll be curtailed.

Nikki Dobay (14:13):

Okay. Okay. I'm glad you level set it with, this is not a crisis. But obviously a lot that the state policymakers are going to have to grapple with. So SNAP and the provider tax pieces definitely will decrease revenues to the extent on the provider tax the states are in the bucket that are impacted. But the Medicaid could is a question mark depending on which direction the state really wants to go. And I think as you and I know there's going to be states that go all in one way and all in the other way and then a couple in between. And it's interesting because I was talking to a policymaker in a west coast state this morning and that person was saying on the Medicaid, we're still trying to understand who is really going to be cut. We don't even know what the numbers are as of yet. Does that one also go into effect in 2027 so policy makers will have time in 2026 to deal with that?

Jared Walczak (15:19):

Yeah. Work requirements go into effect later as well.

Nikki Dobay (15:22):

Okay. Okay. All right. Anything else on that topic before ... Because I think we're keeping it high level and fast today and we want to get to the international stuff before I let you go, but anything else on that topic before we move on?

Jared Walczak (15:39):

I would just say in thinking about all of this, that we should also think of it in the context of where state revenues are. So since the beginning of the pandemic state tax revenues are up 19.4% in real terms. Inflation adjusted terms, were up 19.4%. And it's accurate to say we're plateauing. That even we've seen a bit of a reversion. In the last year we saw 40 states see a decline in revenue. But it was a decline from them being like 20% up and now they're 19% up and that is a really good place to be. There's a lot of reasons behind why states have seen such dramatic tax revenue growth. Over the last two decades it's been about 50% growth in real terms. A lot of this been concentrated in the last five. So as states think about some things that do pull back their revenue a little, of course they have to care about those, but they should also think of them in the context of having an awful lot of revenue growth in recent years. Having some buffer, having some ability to make decisions that you don't have to rush into tax increases or really hard policy choices if you've been prudent because your revenues are just so vastly higher than they were a few years ago.

Nikki Dobay (16:48):

So if I'm reading between the Jared Walczak lines, I'm hearing that this is not a time to think about what's the best new revenue raising tax idea. This isn't a time for experimentation. This is a time to stay the course and be prudent and just think about how can we responsibly manage these increases or decreases to revenue, which are real, but we don't have to jump off the cliff and go crazy.

Jared Walczak (17:21):

That's exactly right. Thank you for being my translator.

Nikki Dobay (17:23):

Okay. Okay. Glad to help. All right. So let's just spend a few minutes ... And I know I'm opening up Pandora's box with this and probably a topic we should come back to in a couple of months when we've had some more time to digest it. But the international stuff, GILTI was brilliant at some level and now we have a new acronym. So what's going on there?

Jared Walczak (17:50):

Well, I think when you open Pandora's Box, hope remains, and I'm not sure if hope remains for the states on this. This is too confusing. So yes, we went from GILTI, the tax on global and tangible low-taxed income, which was not in fact a tax on intangible income and not always even low-taxed income, but it did that. To NCTI. Some are calling it NCTI some are calling necktie. I don't know what's going to stick.

Nikki Dobay (18:15):

Okay.

Jared Walczak (18:16):

This is the net CFC tested income. So there's a recursive acronym in there. We have an acronym embedded in an acronym.

Nikki Dobay (18:22):

Awesome. Perfect.

Jared Walczak (18:24):

Great. Essentially there are a number of changes to how US-based parent companies controlled foreign corporations are now taxed and they make a certain amount of sense at the federal level. I'm not saying all of it's great and there are winners and losers in it, but they do have some intuitive basis at the federal level and it's also a net tax cut at the federal level and none of it quite works for states. So let me try at a high level to walk through on this. It's not easy. So a bunch of things are happening, but essentially in the past, because the idea was that we wanted to discourage companies from doing profit shifting as we shifted from a worldwide tax system to a territorial or mostly territorial tax system we didn't want companies to put all their intellectual property abroad, shift all their royalty income, all of the income that grew to intellectual property and just park it abroad where it's being taxed at very low levels in some jurisdictions and not have it taxed less until it's brought back as dividends to the US. That was the concern. So GILTI was a way to find those supernormal returns as they're called. It was a rough and ready way to determine whether something was coming from actual activity abroad or IP abroad by saying if the returns are more than 10% of your tangible assets, that feels like it's IP.

(19:51):

So bring that in, tax it at a reduced rate, but still tax it here. And there's some acknowledgement of foreign taxes paid through tax credits, but bring that in and tax it. The new system doesn't bother trying to figure out what the source of the revenue is. So what used to be, it was the QBI deduction, that 10% threshold is gone. All of the activity, all of the income of these controlled foreign corporations is now taxable in the United States under NCTI. But of course it's still supposed to be about income that was not substantially taxed abroad. About potential profit shifting. So it leans more heavily into the foreign tax credits. It allows you to take more of them than you previously did to try to account for this based on offer foreign tax credits or at least generally they don't.

(20:44):

So basically you have this situation where instead of just the super normal return income, basically all of the income of these CFCs is now potentially taxable in states and the big offset, the foreign tax credits don't apply. So it's just all of it. And then it gets a little worse because we have also to decide how you allocate expenses when the US parent has an expense that's really about supporting or at least partially supporting a foreign company under GILTI. Those expenses had to be allocated by formula to the foreign entity, which reduced the taxable income under GILTI, but of course increased your taxable income for the US parent. Those rules change a little here actually they change pretty substantially here. So now there's less of deduction for GILTI because a lot of that is not being allocated over there.

(21:32):

Also, the deduction that reduced the amount of taxability ... It's called a section two 50 deduction. It happened at 50%, which basically gave you half the ordinary rate. Now it's at 40%, so you get 60% of the ordinary rate. All of those things mean that there is a much larger share of international income subject to tax at the state level because you're not getting that foreign credit the federal government offering. It's being taxed at a somewhat higher rate. And then one more quirk to make the states even more bizarre just as a mechanical aspect of how this works. If you are taking foreign taxes paid by a foreign company and you're imputing it back to the US parent, so you're putting that tax payment into their activity, well, the income that tax was paid on isn't there. You need to actually bring that tax payment into both the company's income and its costs. And that's just an accounting thing. They do the section 78 gross up and that puts it in income and they do the foreign tax credits and that provides the deduction in the credit and it reduces liability. States don't do that part. They do bring in the gross up.

(22:47):

So you're actually being taxed not only on pretty much all of the income of these controlled foreign corporations with really no offset, you're also being taxed on the amount they paid in tax abroad. It's literally a tax on a tax that was paid out of income, but that's not part of their income. It's just like a double tax on the payment of taxes. None of this makes sense. None of this meets the purposes of GILTI or NCTI. It doesn't look like the base at the federal level for NCTI. It's just this really weird distorted tax on international income that states would be imposing. My takeaway is it was bad enough when states tried to tax GILTI, they were taxing the wrong things. There's no good way to apportion it. It's really a mess and really nonsensical to tax NCTI. Just stop doing it.

Nikki Dobay (23:36):

Yes. Yes. Okay. I am going to try to unpack a few of those points. So first of all, the federal level, the goal is really, I guess this is a complicated new regime, but the foreign tax credit is really meant to offset or alleviate the potential double taxation. Is that the baseline of how it's going to work at the federal level?

Jared Walczak (24:02):

Yeah. And again, the basic idea here is that we don't want profits being shifted to really low tax countries. So if you're paying significant taxes abroad, there's not a lot of additional minimum tax to apply here. If you're basically getting out of that, then we apply it.

Nikki Dobay (24:17):

Right. Okay. I have a lot of thoughts on those there, but we're trying to wrap up. So I'll put those aside and we will come back to this topic. But yes, at the state level, this just sounds like a giant disaster. To your point, we've all been struggling with GILTI and apportionment and the mess that creates and it sounds like this creates an even bigger mess that makes less sense and has less connection to what the states are trying to tax when it comes to activity within their jurisdictions.

Jared Walczak (24:53):

That's exactly it. There are some policies that make a certain amount of sense for a federal government to do that it just makes no sense at the state level and it gets distorted. It just looks so different at the state level that it's this very arbitrary and comprehensive on international activity. Why are states taxing that?

Nikki Dobay (25:11):

All right. We're going to leave that there for right now because wrapping up and I just ... We'll do a super-fast surprise non-tax question. Maybe this will get our minds off of all that crazy international tax stuff that we just talked about. So the surprise non-tax question today is if you could live anywhere else in the world ... And I hear it's hot in Washington DC right now, so you might be thinking about where else you might want to live. If you could live anywhere else, where would it be? And for me, this is a pretty easy one because I really love Mexico, so I would live somewhere in Mexico, probably the beachy part because that's my favorite. But I love the food, I love the vibe. It's all great. So Mexico is definitely my foreign place where I would go. How about you, Jared?

Jared Walczak (25:57):

That's a really good question and I would struggle with it. I think I would gravitate towards somewhere with real natural beauty. I'd be thinking whether it's the Canadian Rockies or New Zealand or Switzerland. I think though that there's a lot I love about the US and I would struggle. I've spent some time in Europe. Six months ago I spent some time in Prague and thought Prague is so beautiful. I would love living in Prague. And then you think would I really? I think I'd rather be here in most respects. But it's beautiful. It is wonderful. But I think I would gravitate towards somewhere with really tall mountains.

Nikki Dobay (26:32):

Awesome. Awesome. Well, Jared, thank you so much. Let's plan on regrouping in a couple of months to work through some of these international issues in more depth when we've all got our heads wrapped around them more. So I'm things ... It's going to be like peeling an onion. It's just layer upon layer. So thank you for catching us up today. Thank you for the listeners for tuning in and listening to this episode. Information for Jared and I will be in the show notes and I look forward to being with you again soon on the next GeTtin' SALTy.