ILLINOIS TAX FACTS

TAXPAYERS' FEDERATION OF ILLINOIS 71 • 1 ■ JANUARY 2018

Illinois Consequences of Federal Tax Reform

Federal tax reform passed Congress and was signed into law in late 2017. Commonly known as the "Tax Cuts and Jobs Act", the bill—HR 1, now Public Law 115-97—had its supporters[1], and its detractors[2].

When considering the Illinois consequences of federal tax reform, there are a number of questions to ask:

- How will Illinois' economy respond, in the long and short term?
- How will the changes impact the federal tax liability of Illinois residents and businesses?
- What are the Illinois tax consequences of the changes?

Many pundits and news articles have focused on the first question, and a thorough analysis of all three questions will require years of data-gathering. Nevertheless, the following articles take a look at elements of the second and third questions: (1) How will the interaction between the Illinois tax code and federal changes impact Illinois income tax collections? and (2) How do the federal changes impact Illinois residents' federal tax liabilities?

---

1 See, e.g., Tax Foundation Statement on Final Passage of the Tax Cuts and Jobs Act, 12/20/17, https://taxfoundation.org/statement-final-passage-tax-cuts-jobs-act/

2 See, e.g., An Open Letter to the U.S. Congress, 12/2/17, http://personal.tcu.edu/jharvey/forbes/Economists_Opposition_to_Trump_Tax_Plan.pdf

INSIDE THIS ISSUE

TAXPAYERS' FEDERATION OF ILLINOIS

430 East Vine Street, Suite A ■ Springfield, IL 62703 ■ V. 217.522.6818 ■ www.iltaxwatch.org ■ tfi@iltaxwatch.org

NOTES FROM THE INSIDE. . .

By Carol S. Portman

In this issue of *Tax Facts* we take an initial look at federal tax reform and its impacts on Illinois and Illinois taxpayers.

Our first step in undertaking this project was to understand the federal law itself, and closely examine how the federal changes will interact with Illinois' tax code, which relies heavily (but not entirely) on the Internal Revenue Code. We were especially on the lookout for situations where the changes created unexpected and undesired results, in either direction—a windfall for the State or for particular taxpayers. Fortunately, we identified no major problems. Taxes can get complicated, and there will almost certainly be some necessary tweaks here and there to realign our laws and regulations with their originally-intended consequences, but the glitches we found were relatively minor and are for the most part not covered in the high-level summaries that follow.

Instead, we focus on two of the big picture questions: how do some of the major changes at the federal level impact Illinois tax calculations, and how will Illinois families fare under the new federal law?

Most of the federal changes have fairly straightforward Illinois tax consequences. The tax rate changes at the heart of federal reform are irrelevant, as are most of the individual income tax changes. More of the corporate changes will find their way into the Illinois tax base, but federal tax reform produces no significant windfall nor revenue erosion for the State of Illinois.

Our table of hypothetical households illustrates the impacts of the federal changes. Illinois taxpayers across a broad range of income levels will see reduced federal taxes, at least at first (some of the changes phase out over time). Taxes will increase for some taxpayers, but it appears most will see a tax cut, as the bill's original name (Tax Cuts and Jobs Act) implied.

I thank the TFI members who helped us comb through this complex law. As we and others delve more deeply into the new law, other issues may arise. The good news is that, so far, we have found no great impact.

The Illinois Income Tax: What Does, And Does Not, Change With Federal Tax Reform

By Carol Portman and Mike Klemens

Carol Portman, President of the Taxpayers' Federation of Illinois since January 2013, has been working in the state and local tax arena for over two decades.

Mike Klemens, President of KDM Consulting Inc., does tax policy research for the Taxpayers' Federation of Illinois.

The highest-profile change at both the corporate and individual level in the Tax Cuts and Jobs Act[3] is the reduction in income tax rates. Illinois sets its own rates, so that change at the federal level is irrelevant for Illinois tax purposes. When it comes to calculating the tax base, though—the amount of income to which the tax rate is applied—things get more complicated. Illinois is generally considered a "rolling conformity" state, meaning we adopt federal tax law and automatically change when it changes. As a result, many of the changes in the federal reform bill are already incorporated into Illinois' tax law as well. This is not universally true, however. In the discussion below we describe some of the significant federal changes and how (or if) they impact Illinois taxpayers.

[3] Public Act 115-97 is technically "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Its original label, the Tax Cuts and Jobs Act, was removed from the bill during the legislative process, but is still widely used.

Corporate (and other business entity) income tax changes

Illinois' corporate income tax calculation (and the income tax calculation for taxable trusts and estates, and the replacement tax calculation for partnerships) begins with federal taxable income. To the extent a change in the federal bill changes a corporation's federal taxable income, it will automatically change Illinois taxable income as well -- usually.

Illinois has, however, "decoupled" from the federal tax regime in a few places, for a variety of reasons and in a variety of ways. Usually that means a federal change to those provisions is irrelevant in Illinois, although sometimes the results are less straight-forward. The examples below take a closer look at the Illinois consequences of federal changes in four of the areas where we have decoupled, in whole or in part, from the federal provisions.

Domestic Production Activities Deduction. In the major tax bill that became law in Illinois last summer (SB 9, or PA 100-22), Illinois decoupled from Internal Revenue Code §199, the Domestic Production Activities Deduction. Amounts deducted pursuant to that section on a taxpayer's federal return will have to be added back when a taxpayer calculates its Illinois tax liability for 2017. Section 199 has now been repealed at the federal level, so Illinois taxpayers will no longer need to make that adjustment—starting in 2018, there will be no federal deduction, either. In other words, there will be no change to Illinois tax liability as a result of this federal change.

Bonus Depreciation. A more complicated decoupling example is what is commonly referred to as "bonus" depreciation. Major capital assets are usually used in a business for a number of years, so traditionally, the purchase price is deducted—depreciated—over time, and not fully expensed in the year of purchase. Over the years, the federal government has revised the depreciation schedules, and Illinois has automatically followed suit, with one exception. When the federal government first adopted Internal Revenue Code Section 168(k), which allows taxpayers to deduct a greater portion of an asset's cost in the year of acquisition than the normal depreciation rules would allow, Illinois decoupled from this new bonus depreciation deduction. Illinois did not want to prevent taxpayers from fully depreciating their assets, so established its own depreciation calculations to apply in instances where the federal bonus depreciation was disallowed for Illinois purposes. The law was written in a quirky way, however--its alternative calculations apply only when federal bonus depreciation is at either 30% or 50% of the asset's purchase price.

Bonus depreciation has now been set at 100%, through 2022. In other words, for federal income tax purposes, a taxpayer will be able to deduct the full cost of capital acquisitions in the year of acquisition, rather than having to take the depreciation deduction over time. (After 2022, it falls to 80%, then 60%, 40%, and 20% in the first year, and the rest of the asset's cost will be depreciated over time.) As described above, Illinois will disallow that deduction, but our alternative depreciation deduction won't apply, since it only applies when bonus depreciation is at 30% or 50%. Fortunately, Illinois' depreciation provision allows an asset to be fully depreciated in the last year of its depreciation for federal purposes, so Illinois taxpayers will get to deduct the cost of their capital assets eventually. Oddly enough, this means that in years when the federal bonus depreciation is 100%--the full cost of the asset is depreciated in the year of acquisition—Illinois is fully aligned with the federal scheme and will also allow a 100% depreciation deduction.

This is a good news/bad news situation. The good news: for a few years, Illinois' depreciation deductions will be aligned with the federal. Taxpayers won't have to recalculate depreciation (a cumbersome process), the Department of Revenue won't have to re-examine the issue on audits, and because the full deduction would be allowed eventually, any tax differential is merely a matter of timing, so there is no revenue lost by the state, or additional taxes paid by taxpayers. The bad news: Illinois' law is outdated and complicated, and after 2022 the alignment with federal tax will go away.

International Tax Provisions. Illinois and most states do not tax income earned outside of the US, and have accomplished that by decoupling from a number of federal calculations and creating their own where necessary. The most complicated aspects of federal tax reform are in the international tax arena, but the overall effect is to shift the US tax scheme somewhat, so that less foreign income will be taxed. As a result, some of Illinois' exclusions and deductions may become less significant.

Two new federal provisions—a one-time deemed repatriation of previously untaxed income earned overseas, and the new Global Intangible Low Taxed Income provisions—have generated considerable interest among tax professionals. Illinois will automatically follow both of these base-broadening provisions, as well as the partial deductions designed to reduce the effective tax rate on these income categories, since these changes are to Internal Revenue Code provisions automatically incorporated into Illinois' corporate income tax calculations. Turns out there may be individuals hit by these new base-broadening measures and they may not get the offsetting deductions for Illinois purposes. Our existing exclusion and dividends received deduction provisions will then come into play, just as they do with the other international tax components of federal tax. In other words, Illinois will likely see some additional tax collected because of these new federal provisions, but it is unlikely to be an undue windfall.

Flow-through entities. One of the new provisions in the Tax Cuts and Jobs Act is the deduction for "qualified business income". It allows non-corporate taxpayers to deduct up to 20% of business income from a flow-through entity. The income of these businesses (partnerships and certain corporations electing what is known as "Subchapter S" status) flows through to the business's owners. If the owners are individuals, that income is taxed at the individual rate, which is now considerably higher than the corporate rate, so Congress created this deduction in order to equalize the rate applied to income earned by all entity types. The maximum deduction is 20% of the business income, but it can be lower and depends on a number of factors. These factors include the income of the individual, whether the business is a specified service business, the wages paid by the business, and the business's capital investment. An individual claims this deduction after Adjusted Gross Income is determined, which means this will **not** reduce the individual's income for Illinois tax purposes. However, when calculating Illinois income tax for trusts and estates (which can sometimes owe income tax), Illinois begins with federal taxable income, at which point this deduction has already been taken. This means that for Illinois purposes, individuals do not get the benefit of this deduction, but trusts and estates do.

Individual Income Tax Changes

For an analysis of the possible federal income tax consequences to a range of hypothetical Illinois households, see the companion piece, *Federal Tax Reform Effects on Individual Illinois Taxpayers*, on page 7.

As with the corporate income tax, Illinois' individual income tax calculations begin with a figure from the federal return – in the case of individuals it is Adjusted Gross Income (AGI), so changes made to the calculation of AGI will have an Illinois impact. Most changes in the Tax Cuts and Jobs Act—things like tax rates and brackets, standard and itemized deductions—come after AGI and do not affect the Illinois return. The examples below illustrate how the federal and state tax laws intersect.

Moving expenses. The moving expense deduction provides a clear example of how changes to federal tax law might affect Illinois state taxes. Under prior law, employees whose workplace moved at least 50 miles could deduct their moving expenses when calculating AGI. The Tax Cuts and Jobs Act repealed that deduction, meaning AGI will increase for taxpayers formerly eligible for the deduction. Because Federal AGI is the starting point on the Illinois return, a reduced federal deduction means higher AGI and a higher starting point for Illinois taxation. In other words, Illinois will follow this federal change.

At the federal level in 2015, the most recent data available, the moving expense adjustment was claimed on 1.1 million returns, reducing AGI by $3.7 billion. Extrapolating from that data, approximately 48,000 Illinois returns will see their starting point increased by a total of $155 million. At Illinois' current tax rate, that would generate an additional $7 million or so in additional taxes.

Personal exemptions. Another aspect of the federal changes is the elimination of the federal deduction for personal exemptions. The Internal Revenue Code has been amended to reduce the amount of the federal personal exemption to $0, but the definitions and provisions regarding the provision are otherwise intact. Illinois cross-references those definitions but not the federal exemption amount, so our exemptions remain in place—this federal change will have no impact on Illinois taxes.

We do not know whether, without a personal exemption, the IRS will keep the requirement to report dependents on the return. When the IRS added the requirement that the taxpayer identify each dependent with a social security number over 30 years ago, the number of dependents claimed dropped from 77 million in 1986 to 70 million in 1987. A *Los Angeles Times* article at the time, headlined *The IRS' Case of Missing Children,* observed: "For a lot of years, millions of children were apparently and profitably created not in the usual way but solely through acts of imagination. When it became easier to check on the existence of such claimed exemptions, these 'dependents' simply faded away."

State and local tax deduction. For federal income tax purposes, after calculating AGI, a taxpayer can take either a "standard deduction" or may itemize certain deductions. Changes to these deductions in the federal tax reform bill have no direct impact on Illinois income tax liability, since the calculation is after AGI. However, many states, including Illinois, have noted with concern the new limit on the amount of state and local taxes paid that can be included in the itemized deductions category. See "$10,0000 Limitation on State and Local Taxes Paid" at page 10.

Overall Impact

Illinois, generally speaking, follows much of the Internal Revenue Code when determining corporate and individual income tax liability, but the state tax consequences of the Tax Cuts and Jobs Act are not in lock-step with all of the federal changes. At the individual level, most of the federal changes are to provisions that impact the tax calculation after Adjusted Gross Income is determined, so Illinois will not follow those changes. At the corporate level, Illinois will follow more of the changes to the tax base, but not the rate-changes, and will also continue to respect the mandate that we not tax activity outside the United States. The exact impact of federal reform on Illinois taxes will depend on each taxpayer's situation, of course, but for most, Illinois income tax liabilities are not likely to change dramatically.

Illinois Tax Facts

Illinois Tax Facts is published by the Taxpayers' Federation of Illinois, a nonpartisan, nonprofit organization founded in 1940 to promote efficiency and economy in government. Reprint permission is granted for articles with credit given to source. Annual membership in the Taxpayers' Federation includes Tax Facts and other publications. For additional information write: Taxpayers' Federation of Illinois, 430 East Vine St., Suite A, Springfield, IL 62703, call 217.522.6818, e-mail at tfi@iltaxwatch.org or visit our website at www.iltaxwatch.org. A membership contribution is not deductible as a charitable contribution for federal income tax purposes, but may be deductible as an ordinary business expense. A portion of your membership contribution to TFI, however, is not deductible as a necessary business expense because of the organization's lobbying activity. The non-deductible portion is 25%. TFI is exempt from federal income tax under Section 501 (c)(4) of the Internal Revenue Code.

Federal Tax Reform Effects on Individual Illinois Taxpayers

By Maurice Scholten

Maurice Scholten, Legislative Director of the Taxpayers' Federation of Illinois. Before joining TFI, Mr. Scholten was Senior Legal Counsel for the Senate President's Office where he worked on taxes, pensions, workers' compensation and unemployment insurance. Prior to that, he was at the Department of Revenue and worked at a property tax law firm while in law school. He received a Bachelor of Science in Mechanical Engineering from Iowa State University and a Juris Doctor from the Loyola University Chicago School of Law.

The Federal Tax Cuts and Jobs Act makes a number of changes that impact individual taxpayers. Among other things, it:

- Reduces tax rates.
- Increases the standard deduction from $13,000 to $24,000 for married filing jointly taxpayers ($6,500 to $12,000 for individuals).
- Eliminates personal exemptions, a $4,150 per person and dependent deduction.
- Increases the child tax credit from $1,000 to $2,000.
- Limits the state and local tax itemized deduction to $10,000. Previously, taxpayers could deduct the total amount of state income taxes (or sales taxes) and property taxes paid. (See *A Deeper Dive: The New $10,000 Limitation on State & Local Taxes Paid* on page 10 for a more detailed discussion of the consequences of this particular change.)

Table 1 on page 8 and the following discussion provide some examples of different hypothetical Illinois taxpayers and how they fare with the changes. The scenarios use Illinois tax rates and average amounts from IRS statistics depending on the family's income.

First, we have the Jones Family, which consists of a teacher, a spouse and two children. We assumed the teacher earns $60,000 and the spouse earns $40,000. Under the old law, they would itemize, but under the new law, they take the increased standard deduction. Under the new law, their taxable income is $8,650 higher because of the elimination of the personal exemptions, but the lower tax rates and doubling of the child tax credit more than offsets this. Under the old law, they paid $7,150 of tax compared to $4,739 under the new law. This is a savings of $2,411 or a 33.7% reduction.

Next is the Holmes family who are two professionals without children that earn $250,000 in wages. They pay $22,375 in property and state income taxes, so they are affected by the $10,000 cap. Because of this cap, they will take the standard deduction of $24,000 instead of itemizing. Their taxable income is increased by

TABLE 1. EXAMPLES OF THE EFFECTS OF FEDERAL TAX REFORM ON HYPOTHETICAL ILLINOIS TAXPAYERS

	Jones Family		Holmes Family		Martin Family		Johnson Family		Jamie	
	Teacher Earning $60,000 & Spouse Earning $40,000 with Two Children		Two Professionals Earning $250,000 With No Children		Couple Earning $1,000,000 With Two Children, $00,000 W2 Income, $600,000 from Passthrough		Retired Couple Earning $60,000		Single Individual Earning $35,000 Without Children	
	Old Law	New Law	Old Law	New Law	Old Law	New Law	Old Law	New Law	Old Law	New Law
AGI	100,000	100,000	250,000	250,000	1,000,000	1,000,000	60,000	60,000	35,000	35,000
20% Qualified Business Income Deduction	-	0	-	0	-	120,000	-	0	-	0
State Income Tax	4,950	4,950	12,375	12,375	49,500	49,500	0	0	1,733	1,733
Property Tax	4,000	4,000	10,000	10,000	15,000	15,000	3,000	3,000	0	0
Mortgage Interest	7,500	7,500	13,000	13,000	20,000	20,000	0	0	0	0
Standard Deduction or Itemize	Itemize	Standard Deduction	Itemize	Standard Deduction	Itemize	Itemize	Standard Deduction	Standard Deduction	Standard Deduction	Standard Deduction
Total Deductions or Standard Deduction	16,450	24,000	35,375	24,000	84,500	30,000	13,000	24,000	6,500	12,000
Exemptions	16,200	0	8,100	0	0	0	8,100	0	4,050	0
Taxable Income	67,350	76,000	206,525	226,000	915,500	850,000	38,900	36,000	24,450	23,000
Tax Before Credits	9,150	8,739	44,450	42,819	306,682	253,879	4,883	3,939	3,191	2,570
Child Tax Credit	2,000	4,000	0	0	0	0	0	0	0	0
Total Tax	$7,150	$,739	$44,450	$42,819	$306,682	$253,879	$4,883	$3,939	$3,191	$2,570
Tax Savings	**$2,411**		**$1,631**		**$52,803**		**$944**		**$621**	
Percentage Reduction	**33.7%**		**3.7%**		**17.2%**		**19.3%**		**19.5%**	

$19,475 but they still see a tax decrease of $1,631, a cut of 3.7%.

The Martins are a family of four. The couple earns $400,000 of wage income and $600,000 from a pass-through business. We will assume for this purpose that the couple qualifies for the new 20% deduction for qualified business income in full, or $120,000. (See the discussion of this new deduction at page 4.) They also pay more than $10,000 in state and local income taxes, but will still itemize under the new law. The Martins do not receive the personal exemptions under the old law as they are phased out after $442,500 of income for married filing jointly taxpayers. Additionally, they are not subject to the Alternative Minimum Tax. Their taxes are reduced from $306,682 to $253,879 for a savings of $52,803, or a 17.2% reduction. The vast majority of the savings is from the new deduction on their pass-through income.

The Johnson Family is a retired couple with an adjusted gross income of $60,000. All of the income is retirement income, so they do not pay Illinois state income taxes. They take the standard deduction under both scenarios. They see their tax liability reduced from $4,883 to $3,939 for a savings of $944, a cut of 19.3%.

Finally, we have Jamie who is single without children and earns $35,000. Jamie rents so he does not pay property taxes. He takes the standard deduction and sees a tax decrease of $621, or 19.5%.

As these examples indicate, most taxpayers will see a decrease in their federal income tax liability as a result of the enactment of the Tax Cuts and Jobs Act. As described in more detail in the following article, the savings would have been greater for some taxpayers if the itemized deduction for state and local taxes paid remained unlimited.

A Deeper Dive: The New $10,000 Limitation on State and Local Taxes Paid

By Maurice Scholten

After calculating Adjusted Gross Income, or AGI, for federal purposes, individual taxpayers take certain deductions. The two most significant deductions are the standard deduction and the itemized deductions—taxpayers reduce AGI by the greater of the two. State and local taxes paid is a long-standing and major component of the itemized deductions. If a taxpayer itemizes their deductions, when a taxpayer's state tax liability goes up, their federal liability goes down (although not in the same amount), and vice-versa—if state or local taxes go down, the deduction is smaller and the federal liability goes up.

The new $10,000 limit on state and local taxes paid that can be included in the itemized deductions has broken that traditional inverse relationship between state and local tax liability on the one side and federal tax liability on the other, and has attracted considerable attention and discussion. A rush of Illinoisans prepaid property taxes in December of 2017 in an effort to claim the deduction for the 2017 tax year, before the limitation went into effect. There was also a spike in December estimated income tax payments for the final quarter of the 2017 tax year, even though they are not due until January 15.

While this $10,000 limit will affect taxpayers differently, there are some common scenarios.

Scenario 1: The higher standard deduction provides more benefit than itemization, with or without the cap. For example, a couple paying $14,000 in state income taxes and property taxes and $8,000 in other deductible expenses, such as mortgage interest or charitable contributions would still take the standard deduction of $24,000 and are not adversely affected by the cap.

Scenario 2: The higher standard deduction provides more benefit than itemization, but only because the new cap limits the amount of itemized deductions. This is the case with the Holmes family on page 7. While the $10,000 limit on state and local taxes did affect them, they did not face a tax increase compared to the old law. However, if the $10,000 limit were not in place, their taxable income would be $11,375 lower and they would have seen an additional tax decrease of $2,730. Taxpayers in this category will still likely see a tax decrease compared to current law, but the decrease would have been larger but for the $10,000 cap.

Scenario 3: A taxpayer still itemizes because the itemized deduction is larger than the standard deduction, but the value of the itemized deductions is reduced by the cap. This is the case with the Martin family in Example 3 on page 9. Their itemized deduction is reduced because of the $10,000 cap on state and local taxes. If the cap were not in place, they would be able to deduct an additional $54,500 and reduce their federal taxes by an additional $20,165.

Some states have been looking at ways to minimize the impact on their residents' federal tax returns due to the $10,000 cap. California has proposed creating a new state income tax credit equal to donations made to a state fund. This has the effect of turning state income taxes into charitable contributions. Here in Illinois, HB 4237 has been introduced, and would follow this approach. New York has focused on creating a payroll tax system that would effectively shift tax liability from individual employees (who may not be able to deduct the state taxes paid for federal income tax purposes) to employers (who can deduct the taxes paid). The credit and payroll tax proposals are appealing to state legislators in states traditionally considered high-tax, but would be complicated and raise a number of questions[4].

The credit-for-charitable-donation proposal would only benefit taxpayers that pay more than $10,000 in deductible state and local taxes (income tax or sales tax plus property tax) and who would otherwise take the itemized deduction (scenarios two and three above). The standard deduction has increased to $24,000 for taxpayers filing as married filing jointly ($12,000 for individuals), so fewer taxpayers will itemize than under the previous law, and it is only those taxpayers who are "losing out" on the full deductibility of state and local taxes paid. As illustrated by scenarios two and three above, many Illinois taxpayers are not paying *more* under the new law, but would pay even less without the $10,000 cap on the deductibility of state and local taxes.

There has been significant discussion of the effects of the new limitation on the itemized deduction for state and local taxes paid. Taxpayers have engaged in year-end planning, and state legislatures are considering enacting elaborate new tax credits or structures to restore a benefit to their residents on the federal return. However, as the examples and scenarios above illustrate, even though Illinois is a relatively high-tax state, many taxpayers will still pay less federal income tax under the new law.

4 The New York Department of Taxation and Finance's *Preliminary Report on the Federal Tax Cuts and Jobs Act* , revised 1/23/18, outlines 8 possible "employer compensation expense" tax options, followed by a 3-page listing of issues needing further study. There is also considerable debate as to whether a donation to a state government in exchange for a tax credit would qualify as a federally-deductible charitable donation.

Taxpayers' Federation of Illinois
430 East Vine Street, Suite A
Springfield, IL 62703
V. 217.522.6818

Return Service Requested

NONPROFIT
ORGANIZATION
U.S. POSTAGE
PAID
Springfield, IL
Permit No. 890

TAXPAYERS'
FEDERATION
OF ILLINOIS