Three Federal Tax Conformity Issues South Carolina Must Face

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The South Carolina income tax structure faces significant potential changes as a result of the federal Tax Cuts and Jobs Act (TCJA) of 2017. Because the state's income tax code is linked to the US code, adoption of provisions from this new law is estimated to result in income tax revenue increases,[1] affecting individual state citizens in multiple different manners.

We outline here the major issues facing the state as a result and provide recommendations to mitigate their effect in a manner that further moves the system toward achieving fairness for our hardworking citizens, stability to fund our promises and essential government services, and economic growth that will create the jobs and opportunities of tomorrow.

South Carolina's income tax code is linked to the federal tax code in what is referred to as "static conformity," meaning that each year, the state must decide whether or not to adopt none, some or all new changes in the federal tax code. This is typically a routine annual process with little to no impact on the state.

However, the Tax Cuts and Jobs Act of 2017 has created such sweeping changes to the US tax code, that South Carolina finds itself in a difficult situation regarding the path forward.

Issue #1: The South Carolina income tax code is tied to the federal code using Federal Taxable Income (FTI) rather than Adjusted Gross Income (AGI) as the starting point, making the state susceptible to revenue fluctuations.

South Carolina is one of only six states that uses FTI as its starting point in calculating state income tax. The majority of states (29 states plus D.C.) use Adjusted Gross Income (AGI).[2] The use of FTI makes South Carolina, and these other five states, the most susceptible to revenue fluctuations as a result of the new federal law.

Coupling to the FTI has the effect of passing through any changes to the federal Standard Deduction and Personal Exemption on to state taxpayers, which are the largest changes affecting the most individuals in the federal tax bill. Using FTI also has the combined effect of passing along itemized deduction and pass-through business deduction changes.

Recommendation: Instead of using FTI as a starting point, move to AGI. This modification will set South Carolina in line with most other states and will help to mitigate the extensive changes

[1] "Estimated South Carolina Impact of Federal 'Tax Cuts and Jobs Act' Of 2017." South Carolina Revenue and Fiscal Affairs Office, January 29, 2018.
[2] "Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform." The Tax Foundation. Special Report No. 242, January 2018.

that occur as a result of the changing Standard Deduction, Personal Exemption and itemized deductions, as well as future changes to those values.

Implementation: In addition to requiring SC taxpayers to start with AGI on their SC1040, form changes will also be needed to allow SC taxpayers to subtract out any itemized deductions previously allowed under the previous schedule.

Issue #2: South Carolina conforms to both federal Standard Deduction and Personal Exemption, both of which are changing extensively, resulting in higher state taxes for some taxpayers.

South Carolina is one of six states that conforms to both the federal Standard Deduction and Personal Exemption. As a part of the TCJA, the Personal Exemption has been eliminated ($4,050 per household member), resulting in an increase in FTI. At the federal level, a more generous child tax credit along with the expansion and reduction of federal tax brackets, helps to offset the impact on families with children. At the state level, however, these offsets would not be passed along, resulting in higher state taxes.

Also under TCJA, the Standard Deduction has been dramatically increased, resulting in a reduction in FTI. This decrease will still be outweighed by the increase in FTI from the elimination of the Personal Exemption.

Recommendation: 1.) Either adopt a custom state-level Standard Deduction or adopt the federal Standard Deduction AND 2.) adopt a state-level Personal Exemption calculated and set at a level to minimize the impact on SC taxpayers with families. Use the federal provisions of the TCJA to modify according to inflation each year.

Implementation: The appropriate level of the Standard Deduction and Personal Exemption will require initial calculation by the South Carolina Revenue and Fiscal Affairs Office (RFA) to minimize taxpayer impact as well as maintain revenue neutrality.

Issue #3: Itemized deductions are changing due to the Tax Cuts & Jobs Act (TCJA), resulting in generally higher Federal Taxable Income (FTI) and, thus, higher state taxes for itemizers.

Several deductions from FTI are being limited under the TCJA, most notably, the limit of $10,000 for the state and local tax deduction as well as the cap of $750,000 on the principal value of a house for the mortgage interest deduction.[3] These changes will served to increase FTI and state taxes as a result.

These reductions, combined with the increased Standard Deduction, will have the effect of reducing the number of filers who itemize. In fact, the Tax Foundation estimates that fewer

[3] The removal of deductions for moving expenses and alimony payments will remain regardless of whether SC uses FTI or AGI as a starting point.

than 10% of tax filers will itemize under TCJA (down from the current 30%). Further, under SC tax code, active trade (pass-through) income is not subject to deductions from itemization, further reducing the number of individuals affected.

Recommendation: Since components of itemization are being eliminated, made less advantageous, and affecting a small and shrinking base of individuals, consider eliminating itemization under state tax code. This change, paired with a reduction in marginal rates, will have the effect of broadening the tax base and lowering rates for all taxpayers. Further, it dramatically simplifies state tax code.

Implementation: The revenue effect of combined elimination of itemization and marginal rate reduction would need to be estimated to maintain a revenue neutral state tax structure. Ensuing SC1040 form changes will be required.

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