NAR Issue Brief

2018 Implications of Federal Tax Reform on State and Local Governments

Background:
Following the enactment of federal tax reform (The Tax Cuts and Jobs Act – P.L. 105-97) in December 2017, many states are reportedly reviewing their existing tax provisions to determine what changes they may want to consider, as major changes made to the Internal Revenue Code in the tax reform legislation can have large revenue effects at the state level. For example, media reports indicate several states are particularly concerned with the new law's $10,000 limit on the deductibility of state and local taxes (SALT) and are considering various "work-around" ideas. These include creating a payroll tax to fund various state and local needs, payments to which would be deductible as business expenses to employers, as well as setting up a special charitable fund in lieu of property taxes, contributions to which are designed to qualify for deduction as charitable donations.

While these SALT deduction work-around ideas are interesting and important, there is a great deal of skepticism among many observers as to whether they will be enacted, and if so, whether they will stand up to the scrutiny of the Treasury Department and/or the courts.

Important REALTOR® Provisions:
Meanwhile, there are two other provisions of the new tax law with state tax implications that are of particular importance to REALTORS®. These are the **Section 179** deduction for qualifying business property and the **new Section 199A** deduction for qualified business income from sole proprietorships and pass-through businesses. These two provisions are getting a lot of attention by various states because they have the potential to create large losses of revenue to state coffers, depending on the tax treatment by state laws.

The Section 179 deduction provides an immediate write-off for qualifying equipment or software purchased during the tax year. The Tax Cuts and Jobs Act increased the maximum amount of this deduction from $500,000 to $1 million, and also increased its phaseout threshold by $500,000, to $2.5 million. As of early 2018, thirty-six states "piggy-back" or conform to the federal definition of the Section 179 deduction.[1] This means this deduction will automatically flow-through to taxpayers in those states, unless the states decide to decouple the provision. Some states may seriously consider doing so, as the estimated loss of the provision can be substantial. Thus, this provision may be a target for state lawmakers to cut or create provisions less advantageous for business owners.

The new Section 199A deduction for qualified business income included in the new federal tax law will allow up to a 20 percent deduction from certain net business income earned by sole proprietors, such as independent contractors, as well as pass-through businesses, including partnerships, limited liability companies (LLCs), and S corporations. Bottom line, independent contractors and pass-through business owners with personal service income, including real estate agents and brokers, with taxable income below $157,500 (single returns) or $315,000 (joint returns) may generally claim the full 20 percent deduction. Partial deductions may be allowed for tax returns

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[1] Alabama, Alaska, Arizona, Colorado, Connecticut, Delaware, Georgia, Idaho, Illinois, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, and Wisconsin. Source: Tax Foundation

showing taxable income of up to $207,500 for singles and $415,000 for joint returns. **This new tax deduction has the potential to be very significant for real estate professionals.**

Because of the pervasiveness of sole proprietors and pass-through businesses, this new deduction also could have huge implications for states. The Section 199A deduction is unusual in that it is a deduction from taxable income, and not adjusted gross income (AGI), as is often the case. Therefore, the majority of states that "piggy-back" on the federal tax return at the AGI level will not automatically have this deduction included in the starting point for determining state taxable income. However, six states[2] conform to federal tax laws at the taxable income level and will thus automatically conform to the federal law on the pass-through deduction unless they preemptively act to change their law. Although, this provision may be highly political. Similar to the Section 179 deduction, this could be viewed as a loss of revenue to the state as this provision is advantageous to the business entity or independent contractor.

NAR will continue to provide resources on state tax reform measures. These two provisions are particularly susceptible to political negotiating. State REALTOR® associations should be aware of these measures if debated during this legislative session.

[2] Colorado, Minnesota, North Dakota, Oregon, South Carolina, and Vermont. Source: Tax Foundation