AEG
ANDERSON ECONOMIC GROUP

January 4, 2018

Constance Beard
Director
Illinois Department of Revenue
Willard Ice Building
101 W Jefferson St
Springfield, IL 62702

RE: Tax Cut and Jobs Act; Implication for Illinois State Income Taxes; Requested Clarification

Dear Director Beard:

As you are aware, the federal Tax Cut and Jobs Act adopted into law in late December has enormous implications for federal taxation, and many implications for state taxation as well. While new caps on the state and local tax deductions appear to be of the utmost concern for Illinois taxpayers, I am writing to request that the Illinois Department of Revenue provide clarification on one issue that has gotten little attention in Illinois. Namely, the Tax Cut and Jobs Act has ambiguous implications for standard exemptions in Illinois for 2018 and beyond.

One Interpretation: Large Hidden Illinois State Income Tax Increase

One interpretation of federal and state statute, a version of which was recently asserted by Michigan's Treasury department based on similar statutory language, is the following:[1]

1. The new federal law eliminates the personal exemption for individual filers, joint filers, and their dependents.
2. Section 204 of the Illinois Income Tax Act grants additional exemptions for dependents and joint filers only to the extent that they are allowed in federal statute.
3. Therefore, all of Illinois' income tax payers lost state exemptions for dependents and the additional exemption for joint filers on January 1, 2018.
4. Without taking any state legislative or administrative action, Illinois' state income taxes will increase by approximately $500 million in 2018, based on AEG estimates using data from the IRS Statistics of Income and the State's FY2016 Tax Expenditure Report.

1.Our letter to the Michigan Treasurer on this matter and his response are attached.

Anderson Economic Group Interpretation

Anderson Economic Group analysts are experts in public policy and economics. Our annual business tax burden rankings are used and cited nationally by governments and research organizations, and we have performed studies on the impact of complex tax reforms in states across the country.[2] Our interpretation of the statute is different:

1. The new federal law, in section 11041, does not eliminate the exemptions for filers or their dependents. It sets the "exemption amount" to zero for years 2018 through 2025 for the purposes of federal individual income taxes.
2. The new federal law is explicit that, for other purposes, "the reduction of the exemption amount to zero...shall not be taken into account in determining whether a deduction is allowed...under this section."
3. The same federal law provides for the exemption amount to not only remain in place, but continue to be indexed for inflation, for the purposes of the estate tax.
4. Section 204 of the Illinois Income Tax Act allows additional exemptions for joint filers and dependents. These exemptions remain in place because no change in state law has taken place, and because federal law continues to establish and allow those exemptions.
5. Without any legislative or administrative action, Illinois' income tax payers should not lose any state income tax exemptions in 2018, and should not be subjected to a large income tax hike due to a loss of those exemptions.

Requested Administrative Statement

While I believe the interpretation above is correct and consistent with the spirit and language of the federal law, it is based on our review of a portion of the long and confusing recently adopted federal law, as well as Section 204 of the Illinois Income Tax Act. I acknowledge that there remains ambiguity in the state and federal laws on this issue.

You may determine, after further study, that a clarifying amendment to Illinois statute at a later date would be warranted to address this and other issues. While that would be welcome, this law is already affecting Illinois taxpayers. Businesses will need to make changes in their income tax withholding soon. Given the ambiguity and importance of this issue, in order to provide Illinois taxpayers and businesses with certainty, I request that you make an administrative statement on your interpretation of the law in the absence of any change in state law as soon as possible.

Sincerely,

Jason Horwitz
Director, Public Policy & Economic Analysis

2.You can find our Annual Business Tax Burden rankings report at http://www.andersoneconomic-group.com/Publications/StateBusinessTaxRankings.aspx. Studies on tax reforms and many other topics are also available in the "Reports" section at http://www.andersoneconomicgroup.com.

CC: Governor Bruce Rauner
Attorney General Lisa Madigan

Attachments: Excerpt, Illinois Income Tax Act, Section 204
Excerpt, Tax Cut and Jobs Act, Section 11041
Patrick Anderson Letter to Michigan Treasurer Nick Khouri, December 29, 2017
Response Letter to Patrick Anderson from Michigan Treasurer Nick Khouri, January 3, 2018

Illinois Law

Illinois Income Tax Act

Sec. 204. Standard exemption.

(a) Allowance of exemption. In computing net income under this Act, there shall be allowed as an exemption the sum of the amounts determined under subsections (b), (c) and (d), multiplied by a fraction the numerator of which is the amount of the taxpayer's base income allocable to this State for the taxable year and the denominator of which is the taxpayer's total base income for the taxable year.

(b) Basic amount. ...[E]ach taxpayer shall be allowed a basic amount of $1000, except that for corporations the basic amount shall be zero for tax years ending on or after December 31, 2003, and for individuals the basic amount shall be: ...
...(5) for taxable years ending on or after December 31, 2013, $2,050 plus the cost-of-living adjustment...

(c) Additional amount for individuals. In the case of an individual taxpayer, there shall be allowed for the purpose of subsection (a), in addition to the basic amount provided by subsection (b), an additional exemption equal to the basic amount for each exemption in excess of one allowable to such individual taxpayer for the taxable year under Section 151 of the Internal Revenue Code.

Tax Cuts and Jobs Act

Enrolled Bill HR 1

ART V—Deductions and exclusions

SEC. 11041. Suspension of deduction for personal exemptions.
(a) In general.—Subsection (d) of section 151 is amended—
(1) by striking “In the case of” in paragraph (4) and inserting “Except as provided in paragraph (5), in the case of”, and
(2) by adding at the end the following new paragraph:
“(5) SPECIAL RULES FOR TAXABLE YEARS 2018 THROUGH 2025.—In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026—
“(A) EXEMPTION AMOUNT.—The term ‘exemption amount’ means zero.
“(B) REFERENCES.—For purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.”

Reference link:
https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.xml

ANDERSON ECONOMIC GROUP

December 29, 2017

Mr. Nick Khouri
Treasurer, State of Michigan
Executive Office, Treasury Building
Lansing Michigan 48922

RE: Tax Cut and Jobs Act; Implication for Michigan Income Taxes; Suggested Clarification

Dear Treasurer Khouri:

As you are undoubtedly aware, the federal Tax Cut and Jobs Act adopted into the law several days ago has enormous implications for federal taxation, and many implications for state taxation as well. The conference committee report adopted on December 22 is long and confusing, even by the standards of tax law. I am writing to suggest that the Treasury provide clarification on one issue that has generated significant confusion in the few days since the President signed the Act into law, and which affects Michigan income tax payers starting January 1, 2018.

One Interpretation: Large Hidden Michigan Income Tax Increase

One interpretation, based on a December 22 statement by the governor and the common description of the federal law, is the following:

1. The new federal law eliminates the federal exemption for individual filers;
2. Michigan's income tax act, in section 30, grants exemptions only to the extent that they are granted under federal law; therefore
3. All of Michigan's income tax payers lose their exemptions January 1, 2018; and
4. Without taking any state legislative or administrative action, Michigan's state income taxes will increase by over a hundred million dollars in the year 2018 alone, estimated by taking all exemption amounts and multiplying the aggregate by the Michigan income tax rate.

Recommended Interpretation

My interpretation is different:

1. The new federal law, in section 11041, does not eliminate the federal exemption for individual filers. It sets the "exemption amount" to zero for years 2018 through 2025, for the purposes of federal individual income taxes.
2. The new federal law is explicit that, for other purposes, "the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account..."

3. As further evidence of that, the same federal law provides for the exemption amount to not only remain in place, but continue to be indexed for inflation, for the purposes of the estate tax.
4. Michigan's income tax act, in Section 30, allows exemptions. These exemptions remain in place because no change in state law has taken place, and because federal law continues to recognize and establish exemptions.
5. Without any legislative or administrative action, Michigan's income tax payers will not lose their state income tax exemptions January 1, 2018, and will not be subjected to a large income tax hike due to a loss of their exemptions under state tax law.

Suggested Administrative Statement

While I believe the interpretation listed above is correct, it is based on my first review of only part of the (very long and confusing) recently adopted federal law, as well as section 30 of Michigan's Income Tax Act. I acknowledge that their remains ambiguity in the state and federal laws, and there are undoubtedly other considerations that you will take into account in applying Michigan's income tax given the new federal law, and after further study.

Given the public's interest and concern about this issue, I believe it would be worthwhile for the Treasury department to state its interpretation of the law in the absence of any change in the state law. Unless there is a clear reason otherwise, I recommend to you the interpretation listed above, which I think is consistent with the spirit of the federal law, the principles of federalism, and the most reasonable way to read a very long and confusing federal tax law. Furthermore, the Governor has stated his intention, which I believe is shared by the majority of the legislature, that changes in federal law not cause state taxes to increase.

You may later determine, after fulsome study, that a clarifying amendment to the Michigan income tax act would be welcome to address this and other issues. There may also be conflicts or ambiguities that require other state actions or interpretations of law. However, given the importance of addressing this issue immediately, I recommend that you make an administrative statement on this matter as soon as possible.

Sincerely,

Patrick L. Anderson
Principal & CEO

CC: Governor Rick Snyder
Attorney General Bill Schuette

Attachments: Excerpt, Michigan Income Tax Act, section 30
Excerpt, Tax Cut and Jobs Act, section 11041

Michigan Law

Michigan Income Tax Act

Sec. 30.
(1) “Taxable income” means, for a person other than a corporation, estate, or trust, adjusted gross income as defined in the internal revenue code subject to the following adjustments under this section:
...
...
...
(2) Except as otherwise provided in subsection (7), a personal exemption of $3,700.00 multiplied by the number of personal or dependency exemptions allowable on the taxpayer's federal income tax return pursuant to the internal revenue code shall be subtracted in the calculation that determines taxable income.
...
...
(7) For each tax year beginning on and after January 1, 2013, the personal exemption allowed under subsection (2) shall be adjusted by multiplying the exemption for the tax year beginning in 2012 by a fraction, the numerator of which is the United States consumer price index for the state fiscal year ending...

Tax Cuts and Jobs Act

Enrolled Bill HR 1

ART V—Deductions and exclusions

SEC. 11041. Suspension of deduction for personal exemptions.
(a) In general.—Subsection (d) of section 151 is amended—
(1) by striking “In the case of” in paragraph (4) and inserting “Except as provided in paragraph (5), in the case of”, and
(2) by adding at the end the following new paragraph:
“(5) SPECIAL RULES FOR TAXABLE YEARS 2018 THROUGH 2025.—In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026—
“(A) EXEMPTION AMOUNT.—The term ‘exemption amount’ means zero.
“(B) REFERENCES.—For purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.”

Reference link:
https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.xml

72 (Rev. 04-15)

STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

RICK SNYDER
GOVERNOR

NICK A. KHOURI
STATE TREASURER

January 3, 2018

Mr. Patrick L. Anderson, Principal & CEO
Anderson Economic Group LLC
1555 Watertower Place, Suite 100
East Lansing, MI 48823

Dear Patrick:

Thank you for your December 29, 2017 letter addressing the impact of federal tax reform on Michigan income tax collections.

I agree it's an issue that should be addressed immediately. We can both agree that Congressional action to change the federal personal exemption should not lead to an unintended increase in Michigan's individual income taxes.

But I don't agree with your recommended interpretation of the implication if state law isn't changed.

You are right about the facts. Federal tax reform did not explicitly eliminate personal exemptions, instead setting the value of each exemption at zero.

But state law is clear, the number of exemptions for state taxation is determined by *"the number of exemptions or dependency exemptions allowable on the taxpayer's federal income tax return"*. Since the federal 1040 will not require taxpayers to calculate personal exemptions that have zero value, Michigan residents would not be able to claim personal exemptions on their state tax returns under current state law.

More generally, and more important, we do not want to leave an ambiguous tax situation open for interpretation by individual state officials or the courts. Addressing uncertainty for taxpayers is a key responsibility of the state Legislature. That is why I believe it is incumbent upon the Legislature to clarify the treatment of personal exemptions for state tax purposes in-light-of recent changes at the federal level.

We've known each other almost 30 years. Agree or disagree (and we've done both) I always welcome your views on state fiscal issues.

Sincerely,

N.A. Khouri
State Treasurer

Cc: Governor Rick Snyder
Attorney General Bill Schuette