State-Federal Tax Conformity

A Needed Simplification for Both Massachusetts Taxpayers and the Department of Revenue

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Massachusetts taxpayers and the Department of Revenue both face significant and unnecessary burdens because the Commonwealth's individual income tax is based on a version of the federal Internal Revenue Code (IRC) that is sixteen years old. **The fix is simple: the Massachusetts General Court should update the state tax code to conform to the current version of the IRC**. The benefits of conformity are widespread, and there are a few overarching reasons Massachusetts should update its conformity date:

1. **Conformity is convenient for the state's Department of Revenue**. Conformity offers the ability to piggyback off of federal definitions, audits, and data, which eases administrative challenges for the Department of Revenue.
2. **Conformity is helpful for taxpayers**. Calculating separate returns because the Massachusetts code is not closely linked to the federal code is inefficient and burdensome.
3. **Conformity in no way impacts the legislature's authority to make tax policy decisions for Massachusetts**. The legislature will still retain full control over the policy decisions, and can choose to selectively decouple.

There is no economic or tax policy reason for Massachusetts not to update its conformity date. It's a routine action that nearly every other state has taken in order to increase simplicity for the Department of Revenue and taxpayers. The Massachusetts legislature should immediately take action to catch up with its peers and end its antiquated approach to conformity.

What is conformity?

For the administrative ease of taxpayers and the Department of Revenue alike, nearly all states base their individual income tax on the Internal Revenue Code (IRC) and its definitions and rules. Put simply, close conformity reduces tax complexity.

There are two ways that a state can conform to the IRC: through static or rolling conformity. Static conformity is when a state conforms to the IRC as of a certain date, and nothing in the tax code will change until legislators vote to update the conformity date. Rolling conformity means the state automatically conforms to IRC changes as they occur, so the state is always coupled to the most up-to-date version of the IRC.

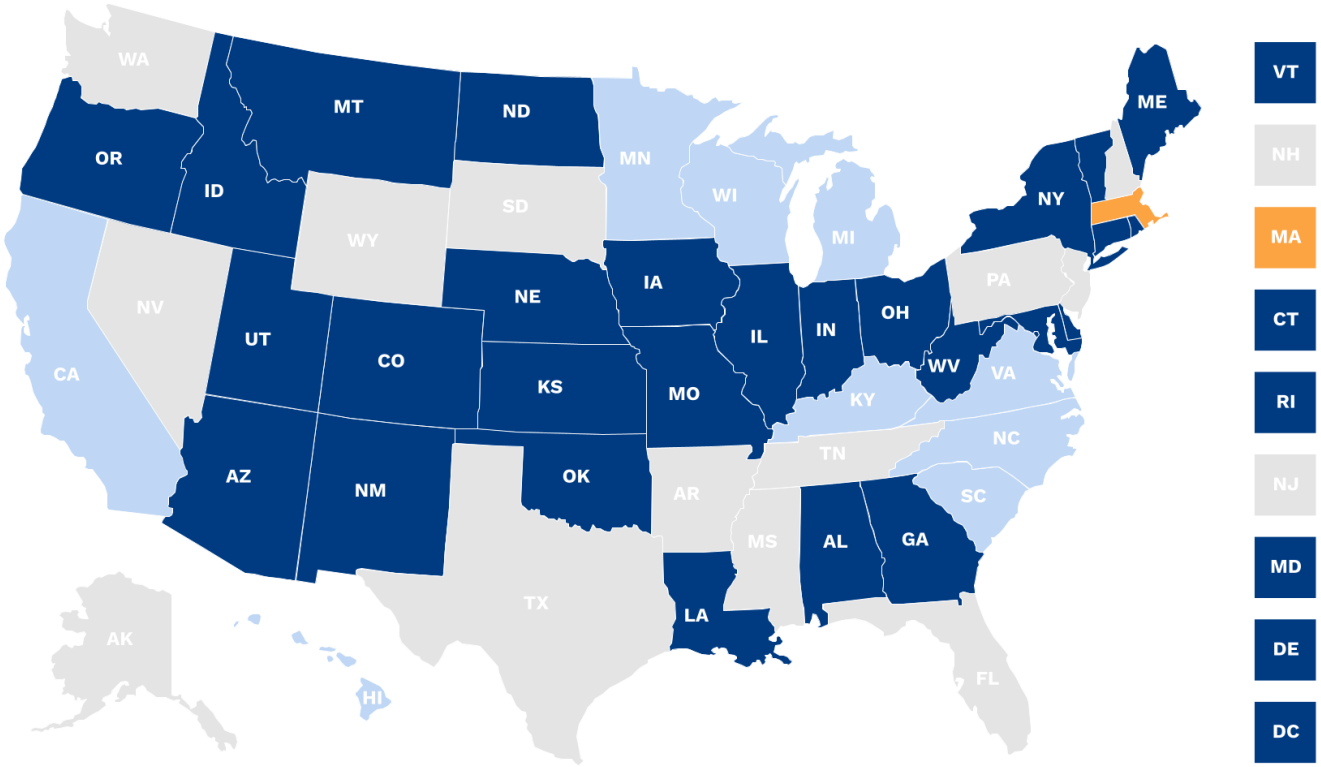
Massachusetts uses static conformity. Although no state conforms perfectly to the IRC, Massachusetts is a significant outlier. Massachusetts is the only state conforming to the IRC as of 2005 — a grossly outdated conformity date. The next closest state is California, which conforms to a 2015 version of the tax code. Every other state conforms to the IRC as of at least 2018, with the majority of states conforming to the 2021 IRC.

The states and DC are evenly split on their conformity approach: 19 states use static conformity, 18 states and DC states use rolling conformity, three states use their own calculations, and nine states do not have an individual income tax.

Massachusetts uses static conformity, but its conformity date is far too outdated.

There's a significant issue with Massachusetts' conformity: the state conforms to a 2005 version of the IRC, which defeats the entire concept of conformity. Not only is this approach problematic, it's also unique: **Massachusetts is a significant outlier in its conformity date, as it is the only state to conform to a version of the IRC older than 2015, and one of only a handful to conform to a version of the IRC older than 2021**. The majority of other states conform to a 2021 version of the IRC. Of the 19 static conformity states: nine conform to the 2021 IRC. Adding in the 19 rolling conformity states, 27 states (plus DC) of the 41 income tax states conform to the current IRC. Of the remainder of static conformity states, five conform to the 2020 IRC, three conform to the 2018 IRC, one conforms to the 2015 IRC, and Massachusetts trails far behind, conforming to the 2005 version of the IRC.

Most states keep pace with the federal IRC, but Massachusetts is an extreme outlier.



Source: MultiState & Thomson Reuters Checkpoint. Data as of September 24, 2021. Notes: Alaska, Florida, New Hampshire, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming do not levy a broad individual income tax. Arkansas, Mississippi, New Jersey, and Pennsylvania don't use the federal IRC as a basis for the income tax.

Why does conformity matter?

Conformity is convenient for states, as they can piggyback off the federal government's definitions, audits, and taxpayer data. States' decision to base their income tax system on the federal system is largely one of convenience. The federal government has developed a sophisticated income tax framework that includes not only the IRC itself, but also regulations, administrative guidance, and case law.[1] This framework is the result of more than a hundred years of imposing the federal individual income tax.

There are several sound policy reasons why states conform their personal income tax codes to the IRC. Conformity lends a level of simplicity to the tax code because the taxpayer is subject to the same definitions and calculations at both the federal and state levels. Additionally, conformity matters because it allows federal and state governments to share taxpayer information to increase taxpayer compliance. There are several programs that facilitate data sharing between the IRS and state revenue departments, with the goal of simplifying tax administration and increasing tax compliance. Conformity has saved states untold funds that would have otherwise been spent on resources to develop a unique individual income tax.

Conformity eases complexity for taxpayers and the Department of Revenue alike. Conformity is an elegant solution because it simultaneously eases burdens for the Department of Revenue and taxpayers. Filing an income tax return is not an objectively simple task, but if states did not conform to the IRS, it would be much worse. Imagine if taxpayers were required to calculate their federal income tax return, and then do a variety of completely separate calculations to determine their state income tax liability. Many taxpayers in fact have to do just that because of Massachusetts' conformity to the relatively ancient 2005 IRC. By updating the conformity date, Massachusetts can help taxpayers avoid this administrative nightmare.

Allowing taxpayers to make these calculations only once increases simplicity, an important characteristic of an effective tax code that can also bolster accurate tax compliance, leading to more state revenue.[2] Law Professor Michael Dorf studied the impact of conformity, and concluded:

> "State tax codes that dynamically incorporate [conform to] the federal definition of income (as well as other aspects of the Internal Revenue Code) provide an example of double savings. First, by piggybacking on the federal definition, the state legislature saves itself and its taxing authority the work of adjusting the law to changing circumstances. Second, this version of dynamic incorporation creates cost savings for taxpayers. Rather than having to calculate their income (and possibly other terms prior to determining their tax liability) once for their federal forms and a second time for their state forms, they can simply copy the result(s) from the federal form to the state form."[3]

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[1]Stark, Kirk J., The Federal Role in State Tax Reform (December 1, 2010). Virginia Tax Review, Vol. 30, p. 407, 2010, UCLA School of Law, Law-Econ Research Paper No. 10-15, Available at SSRN: https://ssrn.com/abstract=1718606

[2]"What Are the Benefits of Simpler Taxes?" Tax Policy Center, https://www.taxpolicycenter.org/briefing-book/what-are-benefits-simpler-taxes.

[3] Dorf, Michael C., "Dynamic Incorporation of Foreign Law" (2008). Cornell Law Faculty Publications. 114. https://scholarship.law.cornell.edu/facpub/114

Though it's difficult to quantify the impact, experts across the political spectrum agree that making taxes simpler would likely raise compliance rates, in part because some portion of unpaid taxes are simply because people do not understand the tax code.[4]

In fact, the Massachusetts Department of Revenue itself has indicated that the 2005 IRC conformity date creates auditing and compliance challenges, both for the Department and taxpayers. The legislature should take action to update its conformity date to the most current IRC. Tax law Professor Ruth Mason agrees: "By minimizing differences between the state and federal tax bases, conformity eases taxpayer compliance, enhances state enforcement efforts, and conserves state legislative resources."[5]

Past actions on conformity have led to greater simplicity.

When the legislature last updated the IRC conformity date from 1998 to 2005, Massachusetts streamlined at least twenty-two provisions to align with updated federal definitions.[6] That action covered only a seven-year period of conformity delay and the period did not include a generational federal tax reform bill. The current clock is ticking at over 16 years, and with an intervening federal tax reform. Massachusetts acting to update to a current version of the IRC would bring significant simplification and clarity to its tax code.

The legislature will not forfeit any control over the tax code – and the revenue impact is minimal.

By coupling to the current IRC, legislators do not lose any control over the Massachusetts Code. Conforming would simply couple the Massachusetts code to current IRC definitions and details, but the Massachusetts legislature will still retain full control over state-specific deductions and exemptions. For example, Massachusetts sets its own personal exemption and standard deduction amounts, so conforming to the federal code would have no impact on those state-specific determinations. Additionally, the legislature holds full authority to decouple from certain federal provisions if policymakers determine conformity would not benefit the state or its taxpayers.

In addition to retaining full control over the tax code, updating the conformity date also would have an extremely minimal impact on the state's revenue. According to the Department of Revenue, conformity would only cost the state roughly $32.9 million (excluding the 20 percent pass-through deduction, which is a policy choice for states). For a state with a total budget of nearly $60 billion and with the expectation of a continued economic recovery, this revenue impact is nominal for the state.

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[4]Gale, William G. "Tax Simplification: Issues and Options." Testimony to Congress, July 17, 2001. https://www.brookings.edu/testimonies/tax-simplification-issues-and-options/

[5] Mason, Ruth. "Delegating Up: State conformity with the Federal Tax Base" (2013). Duke Law Journal, Vol. 62, No. 7. Available at: https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=3382&context=dlj

[6]"Tir 98-15: The Effect of the Adoption of the Updated Internal Revenue Code on the Massachusetts Personal Income Tax ('Code Update')." Mass.gov, https://www.mass.gov/technical-information-release/tir-98-15-the-effect-of-the-adoption-of-the-updated-internal-revenue.

Appendix A: Specific Differences Between the Massachusetts Personal Income Tax and the Federal IRC

Source: Massachusetts Department of Revenue. Note: this list is not all-inclusive (see full DOR list here).

Income Items Included in Massachusetts Taxable Income but not Federal Taxable Income:

- Alimony received is generally included in Massachusetts taxable income although it may not be subject to federal tax.
- Olympic and Paralympic Medals and Prizes are included in Massachusetts taxable income based on the amount of cash winnings and the price of bullion contained in the medals, although these items are not subject to federal tax.
- Public Safety Officers' Death Benefits are included in Massachusetts taxable income but are not subject to federal tax if the officer dies from injuries incurred in the line of duty.
- Student Loans Discharged on Account of Death or Disability are included in Massachusetts taxable income but not federal taxable income. Massachusetts follows IRC §108 in effect as of January 1, 2005.
- Transportation Fringe Benefits are partially excludable from both Massachusetts and federal taxable income. However, the maximum exclusion is higher for federal purposes.
- Wrongfully Incarcerated Individuals may exclude amounts received as legal damages resulting from their wrongful incarceration for federal tax purposes, but such damages are included in Massachusetts income.
- Mortgage Debt Forgiveness results in taxable cancellation of debt income in Massachusetts but such income is excluded from federal taxable income if the debt is forgiven on or before January 1, 2021.

Deduction Items Included on both Massachusetts and Federal but with Differences:

- Claim of Right Deduction is not allowed at the federal level for certain payment amounts. Massachusetts allows the deduction in the year of repayment, provided the amount was previously included in Massachusetts taxable income and the repayment isn't otherwise deductible in determining Massachusetts income.
- Interest on Student Loans deduction is allowed at the federal level for interest paid by the taxpayer, up to an annual maximum of $2,500, for a qualified education loan for both undergraduate and graduate education subject to taxpayer income limitations. Massachusetts allows 2 student loan interest deductions for interest paid on a "qualified education loan" up to $2,500. The federal deduction is for both graduate and undergraduate student loan interest paid and Reported on Schedule Y, Line 10, which has a maximum amount allowed. The Massachusetts deduction for interest paid on a qualified undergraduate student loan which is

Reported on Schedule Y, Line 12, is unlimited. The same taxpayer may claim both deductions on the same return, provided the deductions are not taken for the same interest payments.

- Section 179 and Bonus Depreciation deductions are allowed on the federal level for the cost of specified properties in the year in which those properties are placed in service. Massachusetts allows the Section 179 deduction on a limited basis and disallows the bonus depreciation deduction.
- Adoption Expenses are a federal credit with a cap. Massachusetts allows a deduction for the full amount of fees paid to a licensed adoption agency.
- Gambling Losses in Massachusetts are deductible only if incurred at a gaming establishment or race meeting licensed by the Commonwealth.
- Qualified Small Business Stock is a Massachusetts exclusion for the sale of qualified small business stock, with modifications. The state follows the same qualified small business guidelines, but the business must be incorporated on or after January 1, 2011 and stock must be acquired within five years of the businesses incorporation. Also the state follows the same investor qualification guidelines and rules for after the stock is acquired, except the holding period for Massachusetts is three years not five. If the guidelines and rules are followed, the capital gains will be taxed at a rate of three percent instead of the state's long-term capital gains tax of five percent.

Appendix B: Conformity Status of States

Source: MultiState & Thomson Reuters Checkpoint.

State	Type of Conformity	Conformity Date (Static States)
Alaska	No individual income tax	
Alabama	**Rolling**	
Arkansas	Other	
Arizona	**Static**	March 2021
California	**Static**	January 2015
Colorado	**Rolling**	
Connecticut	**Rolling**	
DC	**Rolling**	
Delaware	**Rolling**	
Florida	No individual income tax	
Georgia	**Static**	January 2021
Hawaii	**Static**	December 2020
Iowa	**Rolling**	
Idaho	**Static**	January 2021
Illinois	**Rolling**	
Indiana	**Static**	March 2021
Kansas	**Rolling**	
Kentucky	**Static**	December 2018
Louisiana	**Rolling**	
Massachusetts	**Static**	January 2005
Maryland	**Rolling**	
Maine	**Static**	April 2021
Michigan	**Static**	January 2018
Minnesota	**Static**	December 2018

State	Type of Conformity	Conformity Date (Static States)
Missouri	**Rolling**	
Mississippi	Other	
Montana	**Rolling**	
North Carolina	**Static**	May 2020
North Dakota	**Rolling**	
Nebraska	**Rolling**	
New Hampshire	No individual income tax	
New Jersey	Other	
New Mexico	**Rolling**	
Nevada	No individual income tax	
New York	**Rolling**	
Ohio	**Static**	March 2021
Oklahoma	**Rolling**	
Oregon	**Static**	April 2021
Pennsylvania	Other	
Rhode Island	**Rolling**	
South Carolina	**Static**	December 2020
South Dakota	No individual income tax	
Tennessee	No individual income tax	
Texas	No individual income tax	
Utah	**Rolling**	
Virginia	**Static**	December 2020
Vermont	**Static**	March 2021
Washington	No individual income tax	
Wisconsin	**Static**	December 2020
West Virginia	**Static**	March 2021
Wyoming	No individual income tax	