

# The Case for Decoupling

*How Federal Tax Changes May Impact Missouri Revenue*

A number of provisions included in the recently passed federal tax law will affect state revenue collections because of the way state and federal tax laws interact. While most of these implications are clear, the way that Missouri's *state personal exemption* for individual income tax is linked with federal law has left ambiguity that could ultimately result in a **\$440 million annual hit to the state budget**. State lawmakers can protect the services that Missourians and communities need to thrive by decoupling from the changes made in the federal tax bill or, at a minimum, by clarifying Missouri's personal exemption statute. **Decoupling in the current legislative session is particularly important for Missouri due to the constitutional restrictions on lawmakers to raise revenue.**

The federal Tax Cuts and Jobs Act, which became law in December, included a number of provisions that will impact state revenue collections due to the interaction of state tax law with federal tax law.

## Definitions: Standard Deductions & Personal Exemptions

Federal and state taxes are not paid on every dollar. Rather, a combination of deductions and exemptions are allowed to determine taxable income.

### Standard & Itemized Deductions

Taxpayers can either claim a standard deduction or itemize deductions, both of which will reduce the income on which taxes are calculated. The standard deduction is a set amount, whereas itemized deductions like mortgage interest, charitable donations, or in certain cases medical expenses or casualty and theft losses, must be tracked & calculated separately. About two-thirds of taxpayers claim the standard deduction.

### Personal Exemptions

In addition to deductions, taxpayers have been able to claim personal exemptions for themselves and dependents, and these exemptions phased out at higher incomes. Under the federal tax bill, there is no personal exemption between 2018 and 2025.

- Some of these changes are quite clear. For example, Missouri's standard deduction for personal income tax is linked directly with the federal standard deduction. The federal tax bill nearly doubled that deduction, effectively doubling Missouri's standard deduction as well.
- However, statutory language defining Missouri's personal exemption is unclear, making it difficult to assess the impact of federal tax changes.
- This lack of clarity may be decided in court. Lawmakers have the opportunity to avoid this confusion, and protect vital services for Missourians by decoupling the state's definitions from federal law.

**At issue is whether the federal personal exemption is eliminated, or whether it exists, but is reduced to zero.**

Missouri's individual income tax statute allows for a *state personal exemption* if a taxpayer is entitled to a federal exemption.

Analysis by the Department of Revenue assumed that federal tax changes **eliminated** the personal exemption resulting in the **elimination** of the Missouri exemption. However, the federal tax law does not actually eliminate the federal personal exemption. Instead, it temporarily reduced the exemption to \$0.

More recent analyses by national experts pointed to ambiguity in Missouri's statute. Ultimately courts could decide that

Missourians are still eligible for a federal exemption. Although federally it would be valued at \$0, it would entitle them to a \$1200 - \$2400 state exemption. **Legislators can resolve this ambiguity by decoupling state definitions from federal definitions.**

# Current Estimated Impacts May Be Based on Incorrect Assumptions

## Current DOR Estimates Assume Federal Exemption is Eliminated

- In December, the Missouri Department of Revenue (DOR) announced that federal tax changes would result in a net loss of \$58 million in state general revenue. While the nearly doubling of the standard deduction could result in a \$700 million loss in state revenue, other provisions would increase state revenue, offsetting some of that loss.
- However, the **DOR projection relied on assumptions that have since been called into question.** An analysis completed by the Economic & Policy Analysis Research Center at the University of Missouri determined that Missouri's personal exemption would be eliminated, effectively offsetting a large portion of the cost of doubling the standard deduction. DOR relied on the EPARC estimate for its own calculations.

## Several recent national analyses of the federal tax law have noted ambiguity in Missouri's statute, which could result in a \$440 million hit to Missouri's budget.

- Missouri's individual income tax statute allows for a state personal deduction if a taxpayer is entitled to a federal deduction. It states:  
*For all taxable years beginning before January 1, 1999, a resident shall be allowed a deduction of one thousand two hundred dollars for himself or herself and one thousand two hundred dollars for his or her spouse if he or she is entitled to a deduction for such personal exemptions for federal income tax purposes."*
- The DOR analysis assumed that the federal tax changes eliminated the personal exemption resulting in the **elimination of the Missouri exemption.** However, the **federal tax law does not actually eliminate the federal personal exemption. Instead, it temporarily reduced the exemption to \$0.** This creates ambiguity in Missouri's statute, which is certain to only be determined by the courts.
- Since Missouri's statute does not entirely conform to federal law, its interaction is unclear and is likely to result in litigation. If the courts were to decide that Missouri's personal exemption remains unaffected by changes to the federal law, Missouri would face a hit to the state budget of \$440 million per year.

## Other Unknowns

There could be additional "latent" errors or unknowns in the federal tax bill that will have yet unknown impacts on Missouri revenue. In fact, the federal bill was drafted, altered and passed so quickly that mistakes are unlikely to be completely avoided. In order to insulate Missouri from any of these unknowns, as well as protect the state from the "known" confusion around the personal exemption, it would be prudent for state lawmakers to fully decouple from the federal tax bill.

**Decoupling in the current legislative session is particularly important for Missouri due to the constitutional restrictions on lawmakers to raise revenue.** If lawmakers wait until after a court makes determinations on Missouri's personal exemption, it may be too late to act. Alternatively, state lawmakers could simply clarify Missouri's personal exemption statute to state that if the federal exemption equals \$0 the state exemption will be eliminated. In either case, the time to act is now.

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1 "The Tax Cuts and Jobs Act of 2017: The Impact on State of Missouri Revenue," G. Dean Crader and Joseph H. Haslag, Economic and Policy Research Center at the University of Missouri, available at <http://eparc.missouri.edu/pubs/tax-cuts-and-jobs-act-of-2017-final-version-2.pdf>

2 Separate analyses conducted by the Institute on Taxation and Economic Policy, the Center on Budget & Policy Priorities & the Tax Foundation have found that Missouri's personal exemption statute does not entirely conform with the federal personal exemption, finding that the interaction with the Tax Cuts and Jobs Act of 2017 is unclear.

3 See Missouri Revised Statute Chapter 143 Section 151 available at <http://www.moga.mo.gov/mostatutes/statutesAna.html>

4 Article X of the Missouri Constitution requires any significant tax increase to go to a vote of the people. Changes to decouple from the Federal tax bill may be determined by the courts to be tax increases if they do not occur in the current year.