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STATE OF VERMONT
JOINT FISCAL OFFICE

MEMORANDUM

To: Rep. Janet Ancel

From: Graham Campbell (JFO), Abby Shepard (Legislative Counsel)

Date: March 26, 2021

Subject: Federal IRC Conformity Options

Rep. Ancel,

In response to the issues presented by the tax provisions in the American Rescue Plan Act (ARPA) of March 2021, the Joint Fiscal Office (JFO) and Legislative Counsel have investigated the options available for the legislature regarding the issue of linking up to federal tax law.

Under Vermont's current statute, the Vermont tax code conforms to the Federal Internal Revenue Code (IRC) as a of a certain date. In the tax policy world, this is known as static conformity. However, Vermont, in practice, has always linked up to the IRC retroactively for the preceding tax year, and the Department of Taxes has always prepared forms with the understanding that the Legislature will conform in the spring of the following calendar year, when returns are filed for the tax year in question. In practice, this is what is called rolling conformity.

The challenge with this system is that when the Federal government passes tax legislation during out-of-session months, particularly later in the calendar year, and if the Department of Taxes assumes rolling conformity (as it has for years), the Legislature has been unable to decouple from any Federal changes without causing administrative hurdles for the Department. In effect, practical control over the state's links to Federal tax changes is removed from the Legislature.

Conformity to Federal tax laws is a complicated issue and every state approaches it in different ways. This memo lays out a broad framework for options the Vermont Legislature can investigate to solve the problem noted above. In short, all the options present advantages and disadvantages.

Option 1: Complete Decoupling from the Federal IRC

This option would involve repealing references to and the explicit adoption of the IRC in statue and creating Vermont definitions.[1] For instance, rather than linking to the definition of Adjusted Gross Income (AGI) as defined in the IRC, Vermont would need to define gross income, each piece of gross income (wages, salaries, dividends, interest, pensions, etc.), and then define Vermont AGI as made up of those components. Many of these definitions could be copied directly from the IRC, but they would become Vermont-specific definitions. In effect, this is Vermont creating its own, separate tax system.

The advantages of this change would be that it would insulate the Vermont tax code from any Federal changes. The Legislature would then have total control over any changes to the system. It could also realign expectations among Vermont taxpayers. Under the current system, since Vermont is linked in many ways to the Federal code, there is an expectation that Vermont should follow. Under our own system, this expectation could change.

JFO and Legislative Counsel see two major disadvantages to this system. First, it is a significant undertaking to identify all the IRC links within the Vermont tax system and replace them. This type of change might not be conducive to the shorter time frame the committee is discussing. The second is it could present administrative issues for the Department of Taxes. For instance, since Vermont would be completely decoupled from the IRC, much of the data that the Department receives from the Internal Revenue Service (IRS) might not be useful for auditing and verification purposes. As an example, under current law, Vermont's Earned Income Tax Credit (EITC) is based upon 36% of the Federal EITC. If Vermont were to completely decouple from the Federal code, the Department might need to create a second worksheet for taxpayers to calculate their Vermont EITC. Additionally, since the Vermont EITC would be decoupled from the Federal EITC, Federal data on EITC claimants might not be as useful to the Department for verification purposes.

Looking at other states, it appears that California, Massachusetts, New Jersey, and Pennsylvania follow a model similar to this Option 1. Massachusetts statute conforms to the IRC as of January 1, 2005 and creates all of its own definitions and calculations for gross income, adjusted gross income, and taxable income.[2] California is also largely decoupled from Federal statute and only appears to link up once every two to five years. California is currently linked to the version of the IRC in effect on January 1, 2015 and has been since tax year 2015.[3] Prior to that, for taxable years 2010 through 2014, California's tax code was linked to the IRC in effect on January 1, 2009. However, the link up language explicitly states that certain IRC provisions do not apply in California,

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[1] The focus in this memo is on the adoption of federal statutes relating to income tax under 32 V.S.A. § 5824, but there is also static conformity for the estate tax under 32 V.S.A. § 7402(8). It is outside of the scope of this memo, but it is important to note that throughout the Vermont statutes, federal definitions (primarily federal adjusted gross income) are incorporated by reference in a way that constitutes rolling conformity. One example is in the definition of household income under 32 V.S.A. § 6061(4)(A) and (5), which reads: ""Modified adjusted gross income" means "federal adjusted gross income" […].

[2] M.G.L.A. ch. 62 §§ 1(c) and (d), 2 and 3.

[3] Cal.Rev. & T.Code § 17024.5(a).

including Federal tax credits and carryovers of federal tax credits. Like Massachusetts, California's statute creates its own tax definitions that mirror those in the IRC.[4]

Option 2: Pure Static Conformity

Another option is to link up to the Federal code as of a certain date and direct the Department to create forms adhering to the IRC as of that date. This is largely the practical effect of the drafted language for H.315.

The main advantage of this option is that it gives the Legislature more control over linkages to the Federal code, as opposed to the Tax Department doing it administratively like it does now. In any given year, the Legislature could maintain the old conformity date but pick up pieces of the Federal code to which it wants to conform. About half of the states with a personal income tax code are statically conformed.

However, this option does not solve the timing issues related to out-of-session Federal tax changes or Federal tax changes that apply retroactively. Suppose the Legislature passed link up language for tax year 2020 setting IRC conformity as of December 31, 2020. The Department would be directed to craft forms and work with software vendors to comply with the IRC as of that date for tax year 2021. If the Federal government passes a major tax bill in November 2021, and the Legislature wants to pick up some provision in that bill, it would be very difficult: the Legislature would have to convene and pass either a new conformity date or pass a bill specifying which provisions it wanted to link up to. Even if that were done, the Department would likely also be in a difficult position to change the forms if the Legislature even made those changes.

While an advantage of static conformity is that it prevents unwanted Federal provisions from flowing through automatically, on the inverse, one disadvantage is that it is that it requires action on the part of the Legislature to incorporate any desired Federal provisions. For instance, under a pure static conformity regime for corporate income taxes, the Tax Cuts and Jobs Act provisions regarding corporate repatriation for foreign profits would have required specific legislative action to pick up. Under the current system, our definitions automatically picked up these changes.

The following states use static conformity: Arizona, Arkansas, California, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Massachusetts, Minnesota, Mississippi, New Jersey, North Carolina, Ohio, Pennsylvania, South Carolina, Vermont, Virginia, West Virginia, and Wisconsin.[5]

One approach to last-minute changes to conformity is taken in Arizona, where the tax code holds taxpayers harmless for penalties and interest when a taxpayer files and pays, relying on the department's published forms and instructions, then conformity does not occur. The hold harmless provision applies when the department supplements its

[4] Cal.Rev. & T.Code, Div. 2, Part 10.

[5] A.R.S.A. § 43-105(A); A.C.A. § 26-51-403, et. seq.; G.C.A. § 48-1-2(14); H.R.S. § 235-2.3(a); I.C. § 63-3004; I.C.A. § 6-3-1-11; K.R.S.A. § 141.010(15)(b); 36 M.R.S.A. § 111(1-A); M.G.L.A. 62 § 1(c); M.S.A. § 290.01(31); N.C.G.S.A. 105-228.90(b)(1b); O.R.C. § 5701.11; H.B. 197 of 2020, eff. March, 27, 2020; S.C.C. 1976 § 12-6-40(A)(1)(a); 32 V.S.A. § 5824; V.C.A. § 58.1-301(B); W.V.C., § 11-24-3(a) and (c); W.S.A. 71.01(3).

published forms and instructions related to nonconformity and requires the taxpayer to file an amended return, provided that the taxpayer amends their return to report the nonconformity deficiency and pays the additional tax due by the extended due date of the next taxable year's return.[6]

Wisconsin has static conformity to certain date (Dec. 31, 2017) after which no federal changes will flow through to the state unless there is an explicit provision allowing it.[7]

Option 3: Pure Rolling Conformity

Under this option, Vermont would automatically conform to any Federal changes to the IRC. This, in practice, is what the Department of Taxes has been doing, since our conformity date has always been passed retroactively. Administratively, the Department has assumed pseudo-rolling conformity when it begins the process of making tax year forms in August of any given year.

The advantages of rolling conformity are that for desirable Federal tax provisions that the Legislature wants to pick up, it does not require any legislative action. If the Legislature wants to decouple from certain provisions, it can keep rolling conformity, but simply decouple from certain provisions.

However, like static conformity, it does not solve the issue of out-of-session Federal tax changes or Federal tax changes that apply retroactively. If the Federal government passes major tax legislation in November of a given year, rolling conformity would automatically pick up these provisions. However, if there were provisions that the Legislature did not want to pick up, it would require convening the Legislature and passing legislation specifically decoupling from those undesirable provisions. It would also create administrative issues for the Department, who would likely have already created the forms and software and provided them to the electronic filing software vendors by that point.

The following states use rolling conformity: Alabama, Colorado, Connecticut, Delaware, Illinois, Kansas, Louisiana, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Oregon, Rhode Island, Utah, and the District of Columbia.

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[6] A.R.S.A. § 43-107.
[7] W.S.A. 71.01(3).